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Supreme Court, U.S.
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No. A - 59

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1991

James and Nancy L. Karr, Petitioner

v.

Commissioner of Internal Revenue,
Respondent

PETITION FOR WRIT OF CERTIORARI TO THE
11TH CIRCUIT COURT OF APPEALS

APPENDIX TO

PETITION FOR WRIT OF CERTIORARI

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APPENDIX A

James KARR and Nancy L. Karr,
Petitioners, V.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

No. 90-8000

UNITED STATES COURT OF APPEALS FOR THE
ELEVENTH CIRCUIT

924 F.2d 1018; 1991 U.S. App. LEXIS 2892;
91-1 U.S. Tax Cas.
(CCH) P50,113

February 27, 1991

Appeal from a Decision of the United States Tax Court (Georgia Case); No. 309-87.

Dennis N. Brager, Los Angeles, California,
Jackson D. Hamilton, Spensley, Horn, Jubas
& Lubitz, Los Angeles, California.

Shirley D. Peterson, Asst. Atty. Gen.
Tax Division, Washington, D.C., Gary R.
Allen, Chief, Appellate Section, Tax
Division, Kenneth W. Rosenberg, Tax
Division, Mary Frances Clark, David I.
Pincus, Washington, D.C.

JUDGES: Johnson and Hatchett, Circuit
Judges, and Dyer, Senior Circuit Judge.

HATCHETT, Circuit Judge

In this tax case, we affirm the Tax Court holding that the transactions in question constituted sham transactions, subjecting the taxpayers to deficiencies, additions to taxes, and interest.

FACTS

Richard Basile was a promoter of energy-related limited partnerships. In 1981, he discussed a possible K-Fuel project with a Swiss investor, with whom Basile had an ongoing relationship. K-Fuel is a dry, stable, high heating value solid fuel, physically resembling coal, which is produced by placing wood, peat, lignite and other low-grade biomass or fossil fuel into a Koppelman reactor, where it is dried and carbonized at high temperatures and pressure (the Koppelman

process). This technique was developed by Edward Koppelman.

As part of an intricate network of interrelated entities formed to exploit the Koppelman process, Intro-Continental Investment, B.V. (Intro-Continental) was established. Basile received a 15-percent interest in Intro-Continental and in its wholly owned subsidiary, Ronodo Corporation, N.V. (Ronodo). Basile also became Chairman, Chief Executive Officer, and President of Petro-Syn Corporation (Petro-Syn), in which he owned a 35-percent interest.

In August, 1981, Ronodo licensed from Koppelman the exclusive right (as well as other rights) to use the Koppelman process within the state of

North Carolina to refine peat and wood into K-Fuel. All of these rights were sublicensed by Ronodo to its wholly owned subsidiary Sci-Teck Licensing Corporation (Sci-Teck).

Peat Oil and Gas Associates, Ltd. (POGA) and Syn-Fuel Associates, Ltd. (SFA) were also formed as part of the network, allegedly to exploit Koppelman process technology and to acquire and develop oil and gas interests. According to the nearly identical offering memoranda, each partnership offered 125 to 250 limited partnership interests. The memoranda described POGA's general partner as a certified public accountant and financial consultant and SFA's general partner as a tax and financial consultant. Neither general partner had

any technical background relevant to the partnerships' proposed activities.

The memoranda estimated tax losses during the initial four years of the partnerships' operations to average 401 percent. Thus, each investor purchasing one partnership unit for a \$ 37,500 cash investment could deduct \$ 150,376 in tax losses over four years. In order to be eligible to purchase units in the partnership, a prospective limited partner was required to fill out an Offeree Suitability Questionnaire, representing that the person had a net worth of at least \$ 250,000 (exclusive of home, furnishings and automobiles) and was subject to federal income tax at the highest brackets. The memoranda also clearly warned that financial success in

terms of K-Fuel development was highly unlikely. Factors cited included (1) commercially unproven technology; (2) lack of experience; (3) conflict of interests; (4) large obligations incurred without arm's-length negotiations; (5) environmental and health problems; (6) severe competition; and (7) inadequate capital (after payments to the promoters and their associates).

POGA and SFA entered into a joint venture agreement to own and operate a pilot K-Fuel plant in North Carolina.¹ The partnerships licensed from Sci-Teck the exclusive right within the state of

¹ By 1984, the Koppelman process plant had been built. Nevertheless, only a few bucketfuls of K-Fuel ever were produced at the North Carolina plant. As of 1988, it had been two years since equipment at the plant last had been operated, and the equipment had been partially dismantled.

North Carolina to use the Koppelman process with respect to peat and wood as well as the nonexclusive right to use the Koppelman process in the remainder of the United States with respect to any material other than bagasse. At the end of 1981, the partnerships also entered into a research and development agreement with Fuel-Teck Research and Development (FTRD), a wholly owned subsidiary of Petro-Syn. FTRD's role was to conduct and coordinate the research and development efforts for the benefit of the partnerships, and to oversee construction of the Koppelman process plant.

POGA agreed to pay a license fee to Sci-Teck which included both cash and partnership notes of \$ 112,175 for each partnership unit sold. Specifically, for

each partnership unit sold, POGA agreed to pay \$ 12,975 in cash between October 1, 1981, and October 1, 1984, and \$ 99,200 in promissory notes due between October 1, 2006, and October 1, 2009. POGA also agreed to pay FTRD a fee for its services. The structure of this payment required POGA to pay FTRD, for each partnership unit sold, \$ 5,000 in cash between October 1, 1981, and October 1, 1982, and \$ 24,800 in promissory notes due between October 1, 2006, and October 1, 2007.

The partnerships' oil and gas investments were to partially subsidize the efforts to develop the Koppelman process. Fuel-Teck Oil and Gas, Inc. (FTOG), another wholly owned subsidiary of Petro-Syn, was to be responsible for

those oil and gas activities. The revenue derived from oil and gas projects would be used to pay off POGA's notes to Sci-Teck and FTRD.

James Karr became a limited partner in POGA in December, 1981. He purchased one unit as a tenant in common with Robert Bluhm. Karr's purchase called for payment of \$ 80,750 over a 26-year period. Karr's obligations to POGA were embodied in full recourse promissory notes. Karr timely made payments of all amounts, including interest due to POGA, between 1981 and 1984. On December 29, 1981, Karr entered into an agreement with Sci-Teck and FTRD pursuant to which he agreed to assume personal liability for POGA's obligations in the amounts of \$ 49,600 and \$ 12,400.

On its income tax return for 1981, POGA deducted \$ 4,288,375 as a license fee to be paid to Sci-Teck and \$ 4,288,375 as a research and development fee to be paid to FTRD. The amounts represented accrual of the notes and cash payments due on 211.25 partnership units, determined as of the date the 1981 income tax return was prepared. On its 1982 income tax return, POGA deducted \$ 5,830,500 as a license fee to be paid to Sci-Teck and \$ 1,964,625 as a research and development fee to be paid to FTRD. For 1982, POGA also deducted \$ 505,897 as interest expense and reported \$ 428,455 as interest income on notes receivable.

On their joint income tax returns for 1981 and 1982, James and Nancy Karr deducted \$ 20,191 and \$ 19,593,

respectively, as their distributive share of partnership losses. The Commissioner of Internal Revenue disallowed these deductions on the ground that the activity in which POGA was engaged was not entered into for a profit. The Commissioner also asserted that the purported liability underlying POGA's claimed \$ 505,897 interest expense deduction was contingent and that the notes lacked economic substance. Accordingly, the Commissioner determined deficiencies in the Karrs' federal income tax of \$ 8,907 for 1981 and of \$ 7,972 in 1982, and assessed an addition of \$ 797 to their 1982 tax.

PROCEDURAL HISTORY

The Karrs petitioned the Tax Court

to redetermine the tax deficiencies set forth in the notice of deficiency, and their case was selected as one of two test cases involving the POGA and SFA partnerships.² Following a week-long trial, the Commissioner conceded that the Karrs could deduct their distributive shares of partnership losses attributable to oil and gas investments. Consequently, the Tax Court addressed the Karrs' claimed deductions for distributive shares of losses represented by POGA's payments to Sci-Teck for license fees and to FTRD for research and development fees.

The Tax Court held that the Karrs were not entitled to the claimed

² The other test case is now on appeal in Dean B. Smith and Irma Smith v. Commissioner (6th Cir. No. 90-1007).

deductions. Smith v. Commissioner, 91 T.C. 733 (1988). The Tax Court determined that tax motivations shaped the limited partnership transactions in question and that POGA's Koppelman process activity lacked economic substance apart from the anticipated tax benefits. In addition, the Tax Court determined that such activity was not within the scope of section 174 of the Internal Revenue Code.³ The Tax Court also sustained the addition to tax under section 6661(a) for substantial understatement of income tax, and the imposition of additional interest under section 6621(c) on substantial

³ Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and in effect during the years in issue. The 1954 Code has since been redesignated as the Internal Revenue Code of 1986. See Tax Reform Act of 1986, Pub.L. No. 99-514, 2, 100 Stat. 2085.

underpayments attributable to tax motivated transactions.

CONTENTIONS

The Karrs contend that the Tax Court erred in determining that POGA's Koppelman process activity was primarily motivated by tax benefits and lacked economic substance. The Karrs also contend that even if the primary purpose of POGA's activities was the avoidance of tax, the claimed amounts are deductible. Finally, the Karrs contend that without regard to whether the other expenses incurred in connection with the Koppelman process activity are deductible, the interest on the partnership notes is deductible.

The Commissioner contends that the Tax Court correctly ruled on all issues.

ISSUES

The issues are: (1) whether the Tax Court correctly determined that the Karrs are not entitled to deduct their allocable share of partnership losses from the Koppelman process activity; (2) whether the Tax Court correctly determined that the Karrs are liable for additions to tax for substantial understatement of their tax liability; and (3) whether the Tax Court correctly determined that the Karrs are required to pay additional interest for tax motivated transactions on any underpayment.

DISCUSSION

I. Claimed Deductions

On their 1981 and 1982 income tax returns, the Karrs sought to deduct their prorata share of partnership losses arising from POGA's payment of license fees and research and development fees. In their petition to the Tax Court, the Karrs claimed that they were entitled to these deductions pursuant to either section 162 or section 174. Section 162(a) allows deductions for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," and section 174(a)(1) allows deductions for "research or experimental expenditures which are paid or incurred . . . in connection with

[the taxpayer's] trade or business. . . .

" 26 U.S.C.A. (West Supp.1990).

A. Sham Transaction Analysis

Before determining whether a particular activity arises in or is connected with a trade or business, it must first be established that the transaction in question is bona fide and not a sham. A sham transaction is one which, though it may be proper in form, lacks economic substance beyond the creation of tax benefits. Knetsch v. United States, 364 U.S. 361, 365-66, 81 S. Ct. 132, 134-35, 5 L. Ed. 2d 128 (1960); Kirchman v. Commissioner, 862 F.2d 1486, 1491 (11th Cir. 1989). This determination is significant because expenses incurred in connection with a

sham transaction are not deductible. Kirchman, 862 F.2d at 1490. Both the taxpayers' subjective intent and the objective economic effect of the transaction may be relevant to this inquiry. See Kirchman, 862 F.2d at 1491.

In the Eleventh Circuit, the Tax Court's finding that a transaction is a sham is normally subject to the clearly erroneous standard of review; the legal standard applied by the Tax Court in determining if a transaction is a sham is subject to plenary review. Kirchman, 862 F.2d at 1490.

The Tax Court framed the issue as whether POGA was "engaged in the trade or business of developing energy sources from the Koppelman process or [whether it

was] in the business of financing the operations of other entities in exchange for tax benefits."⁴ The activities of the other entities involved in exploiting the Koppelman process, however, cannot necessarily be attributed to POGA. See Beck v. Commissioner, 85 T.C. 557, 574 (1985). After receiving evidence as to the purpose and structure of the transactions, and examining the transactions in light of objective factors, the Tax Court found that the substance of the transactions was that POGA provided cash to finance the promoters' activities for their various projects, and in return, POGA's limited

⁴ The deductibility of POGA's expenditures on the Karrs' federal income tax returns is first determined at the partnership level. See Brannen v. Commissioner, 722 F.2d 695, 703-04 (11th Cir. 1984).

partners would receive tax benefits in the form of deductible losses. The Tax Court concluded that POGA's Koppelman process activity lacked economic substance.

The Karrs initially contend that the Tax Court erred as a matter of law because it applied the "generic tax shelter" test to determine whether the transaction lacked economic substance. According to the Karrs, this test was rejected in Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989), in Collins v. Commissioner, 857 F.2d 1383, 1386 (9th Cir. 1988), and should be rejected by this circuit. The Tax Court, however, did not merely characterize the transaction as a "generic tax shelter," and conclude that the transaction was therefore a

sham. Instead, the Tax Court considered characteristics of generic tax shelters to aid in identifying transactions in which tax motivation is apparent.⁵ The Tax Court correctly focused its analysis upon an examination of the substance of the transactions to determine whether

⁵ Characteristics attributed to "generic tax shelters" in Rose v. Commissioner, 88 T.C. 386, 412 (1977), which the Tax Court found to be substantially present in POGA's transactions, include:

(1) Tax benefits were the focus of promotional materials; (2) the investors accepted the terms of purchase without price negotiation; (3) the assets in question consist of packages of purported rights, difficult to value in the abstract and substantially overvalued in relation to tangible property included as part of the package; (4) the tangible assets were acquired or created at a relatively small cost shortly prior to the transactions in question; and (5) the bulk of the consideration was deferred by promissory notes, nonrecourse in form or in substance.

those transactions had any practicable economic effect other than the creation of tax benefits.⁶

The Karrs next contend that the Tax Court's conclusions are erroneous because the Tax Court never determined that no reasonable possibility of profit existed, nor could it have done so on the evidence presented. According to the Karrs, experts testified that, viewed from the standpoint of 1981, POGA had a reasonable prospect of profitability in that the profit potential was in the range of 25

⁶ Cf. Rose, 868 F.2d at 854 ("[T]he tax court's analysis is correct and consistent with the analysis traditionally applied by this circuit in determining whether a particular transaction is a sham"); Collins, 857 F.2d at 1386 ("Although the generic tax shelter test is not incorrect, it does not aid courts in that basic inquiry [of looking beyond a transaction's form to uncover its substance]").

to 40 percent. The Karrs assert that this testimony was unimpeached, competent, and uncontradicted. Nevertheless, the Karrs' reliance on the experts' testimony is unwarranted given the basis of that testimony. The experts assumed that the Koppelman process plant would be commercially successful, and failed to consider the various risk factors discussed in POGA's offering memorandum.

Although the Commissioner presented no expert witnesses, the record contains substantial evidence from which one may conclude that POGA's Koppelman process activity lacked economic substance and had no business purpose other than the creation of tax benefits. The offering memorandum emphasized the tax benefits of the partnership, including anticipated

tax write-offs for the limited partners of four times their cash investment over the first four years of the partnership. The purchasers of partnership units did not negotiate for the price of their shares and knew of conflicting business interests.⁷ POGA held no tangible assets, and the limited rights to exploit the Koppelman process that POGA did possess were difficult to value. Moreover, the fees paid by POGA to Sci-Teck and FTRD were not the result of arm's-length

⁷ For example, Basile's personal interests conflicted with the interests of POGA and SFA. Basile was President and Chief Executive Officer of Genoco Industries, Inc. (Genoco), and a promoter of Petrogene Oil and Gas Associates (Petrogene). The partnership memorandum warned that Genoco would engage in oil and gas activities similar to those engaged in by FTOG, and that Genoco planned to convert bagasse into synthetic fuel. Basile had a proprietary interest in Petro-Syn, Sci-Teck, Ronodo, Genoco, and Petrogene, all entities which stood to profit at the expense of the partnerships.

negotiations.

The amount and structure of the fees paid by the partnerships also lend support to the Tax Court's conclusion that the transactions lacked economic substance. POGA and SFA incurred a fixed obligation to pay an amount potentially 56 to 112 times greater than the price paid by Ronodo; yet, the partnerships received fewer rights than did Ronodo to exploit the Koppelman process. Another noteworthy difference between Ronodo's payments to Koppelman and POGA's payments to Ronodo is that Ronodo's payments were contingent on the completion and testing of the system's construction and on the commercial success of the Koppelman process technology and exploitation. In contrast, POGA's payments to Sci-Teck and

FTRD were based on a multiple of the number of partnership units sold. Furthermore, the bulk of POGA's payment consisted of promissory notes due in twenty-five years. Although they were recourse notes, the Tax Court found that the substantive liability that they represented was significantly less than the face amount of the notes.

The Tax Court also relied on the testimony of Michael Zukerman, a partner in the law firm of Baskin & Sears. Basile, who was previously a client of Baskin & Sears, brought the firm into the project as legal counsel. Baskin & Sears prepared all the promissory notes, contracts, and assumption agreements entered into by POGA, SFA, and their limited partners. Intro-Continental and

Basile paid the law firm for these services. Zukerman was the Baskin & Sears partner responsible for the project. In that capacity, Zukerman reviewed POGA's offering memorandum and attended many of the meetings involved in the project's formation.

The Karrs contend that Zukerman's testimony is irrelevant to a determination of the business purpose for the partnership. According to the Karrs, Zukerman only acted as a legal advisor to the promoters and the partnerships. He was not in control of the partnerships, and was not involved in making the business decisions which led to the formation of the partnerships. The Tax Court, however, used the testimony in its determination of whether the transactions

lacked economic substance; the focus was not solely on the taxpayers' subjective motivations.

- On direct examination, the taxpayers' counsel asked Zukerman if he had been involved with the structuring of the transaction. He responded, "Yes." Upon further direct examination, Zukerman made statements quoted at length by the Tax Court concerning the reasons that the particular structure was chosen for the transactions. At trial, the Karrs did not suggest that Zukerman was misrepresenting anyone's intentions. Moreover, it was stipulated that the general partners of POGA and SFA relied upon others' advice, including Zukerman and his associate, "both in the operation of the partnership and the initial decision to form the

partnership." Although the general partners did not testify, Zukerman testified that the transactions, and POGA's role in the transactions, "had to do with the tax structure, in order to accomplish the desired tax results, you have to have an independent license from a contract, and the partnership. . . . and the structure was really a tax structure to accomplish the desired tax end."

After careful examination of the record, we conclude that the Tax Court properly analyzed whether the Koppelman process activity involving POGA lacked economic substance, and properly found that those transactions did lack economic substance. Consequently, the expenses arising from those sham transactions are

nondeductible.⁸

B. Interest Analysis

The Karrs contend that regardless of whether the other expenses incurred in connection with the Koppelman process activity are deductible, interest on the partnership notes is deductible if the obligation is genuine. See Rice's Toyota World v. Commissioner, 752 F.2d 89, 96 (4th Cir. 1985). The Karrs had agreed to assume POGA's notes to Sci-Teck and FTRD due in twenty-five years only as to the principal, not the interest. According to the Karrs, the Tax Court found that the

⁸ Because we affirm the Tax Court's holding that POGA's Koppelman process activity is a sham, we need not determine whether the losses sustained from that activity are otherwise deductible under the Internal Revenue Code.

projected revenues from gas and oil well drilling would have been sufficient to completely retire POGA's promissory notes to Sci-Teck and FTRD as to both principal and interest. The Karrs' oil and gas expert testified that the projection set forth by the partnerships was reasonable. The Karrs contend that the Tax Court clearly erred in not finding that the interest on the notes would be paid by POGA without regard to the success of its Koppelman process activity.

Using an accrual method of accounting, an expense is deductible only in the tax year in which all events have occurred which determine the fact of the liability and the amount thereof. Treas. Reg. Sec. 1.461-1(a)(2). Because the interest on the notes was payable only

out of POGA's anticipated revenues, and payment was not due for twenty-five years, the Tax Court did not clearly err in finding that the obligation to pay was too contingent to meet the standards for accruability.

II. Addition to Tax for Substantial Understatement of Tax Liability.

Section 6661(a) provided that "if there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement." 26 U.S.C.A. (West

1989).⁹ A substantial understatement of income tax is one which exceeds the greater of 10 percent of the tax required to be shown on the return for the year or \$ 5,000. 26 U.S.C. Sec. 6661(b)(1). If the understatement is due to an arrangement whose principal purpose is the avoidance of federal income tax, the amount of underpayment is subject to reduction only if substantial authority exists for the taxpayer's position and

⁹ The Karrs' notice of deficiency was mailed previous to the 1986 amendment to section 6661(a) which increased the addition to tax from 10 percent to 20 percent. Pub.L. 99-509, 8002(a). The Commissioner only imposed, and now only seeks, a 10 percent addition to the Karrs' tax liability.

Section 6661 was repealed by Pub.L. 101-239, 103 Stat. 2399 (1989). The imposition of an addition to tax for a substantial understatement of tax liability is now authorized by section 6662.

the taxpayer reasonably believed that his tax treatment of the item was "more likely than not the proper treatment." 26 U.S.C.A. Sec. 6661(b)(2)(C)(i) (West 1989). The section also provided that the Commissioner may waive the addition to tax if the taxpayer demonstrates reasonable cause for the understatement and that the taxpayer acted in good faith. 26 U.S.C. Sec. 6661(c).

On appeal, the Karrs contend that even if POGA's Koppelman process activity lacked economic substance or had as its principal purpose the generation of tax benefits, they were entitled to a waiver of the substantial understatement penalty and the Commissioner abused his discretion in failing to grant such a waiver. The Karrs contend that the

transactions entered into by POGA, and the tax provisions governing those transactions, were complex. The Karrs assert that in preparing their tax returns, they reasonably relied on their accountants and on a letter they received from a national CPA firm assuring them that the deductions shown on SFA's K-1 form were correct.

The review of the Commissioner's decision to not waive the addition to tax penalty is limited to whether the Commissioner's discretion has been exercised arbitrarily, capriciously, or without sound basis in fact. Mailman v. Commissioner, 91 T.C. 1079, 1084 (1988). In this instance, the Karrs have not shown that the Commissioner's position

was maintained for any improper purpose. The offering memorandum set forth detailed possible challenges to POGA's tax claims in the event of an audit. Moreover, the letter from the CPA firm explicitly informed the Karrs that the addition to tax for substantial understatement could be imposed against them. The Tax Court correctly concluded that the Commissioner did not abuse his discretion in this matter.

III. Additional Interest for Tax Motivated Transactions.

Section 6621(c)(1) imposed at the relevant times additional interest on substantial underpayments of tax attributable to tax motivated

transactions.¹⁰ For the purposes of this subsection, sham transactions are included in the meaning of a tax motivated transaction. 26 U.S.C. Sec. 6621(c)(3)(A)(v). Because we affirm the Tax Court's finding that POGA's Koppelman process activity lacked economic substance, the Tax Court correctly determined that the Karrs' tax liability is subject to the imposition of additional interest pursuant to section 6621(c).

CONCLUSION

For the reasons stated above, the Tax Court's decision is affirmed. AFFIRMED.

¹⁰ Congress has subsequently repealed section 6621(c). Pub.L. 101-239, 7721(b), 103 Stat. 2399 (1989).

APPENDIX B

DEAN B. SMITH AND IRMA SMITH, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE,
Respondent; JAMES KARR AND NANCY L. KARR,
Petitioners v. COMMISSIONER OF INTERNAL
REVENUE, Respondent

Docket Nos. 48306-86; 309-87

91 T.C. 733; 1988 U.S. Tax Ct. LEXIS 130;

91 T.C. No. 48

October 3, 1988; As amended October 6,
1988

SYLLABUS:

PS invested in certain limited partnerships and assumed liability for the principal portion of long-term notes given by the partnerships. The partnerships reported the amounts of the notes as license fees and research and development fees and claimed current deductions under

accrued liability under the notes. Held:
The partnerships were not, in substance,
engaged in a trade or business, and the
claimed deductions are not allowable. Ps
are liable for additions to tax under
section 6661 and additional interest under
section 6621(c).

Dennis N. Brager and Jackson D. Hamilton,
for the petitioners.

Martin D. Cohen and William H. Quealy,
Jr., for the respondent.

COHEN, Judge: Respondent determined
deficiencies in and additions to
petitioners, income tax as follows:

Add to Tax

Pet.	Year	Deficiency	Sec.6661 ¹
Smith	1981	\$19,505.00	-
48306-86	1982	13,059.64	\$1,303.00
Karr	1981	8,907.77	-
309-87	1982	7,972.84	797.28

After concessions, the issues for decision are as follows:

(1) Whether petitioners are entitled to deduct their pro rata share of the losses of certain limited partnerships on their 1981 and 1982 income tax returns;

(2) Whether petitioners are liable for additions to tax under section 6659;

(3) Whether petitioners are liable for additions to tax under section 6661 for 1982; and

(4) Whether petitioners are required

¹ Unless otherwise indicated, all section references are to the Internal Revenue code as amended and in effect during the years in issue.

to pay additional interest under section 6621(c) on any underpayment.

FINDINGS OF FACT

I. Background

Many of the facts have been stipulated, and the facts set forth in the stipulation are incorporated in our findings by this reference. Petitioners Karr and Smith resided in Georgia and Michigan, respectively, when their petitions were filed. In each of the years in issue, petitioner James Karr was a limited partner in Peat Oil & Gas Associates, Ltd. (POGA); petitioners Smith were limited partners in Syn-Fuel Associates, Ltd. (SFA). POGA and SFA were putatively formed to exploit a technique known as the Koppelman Process.

The Koppelman Process refines wood, peat, lignite and other low grade biomass

or fossil fuel into a dry, stable, higher heating value solid fuel, physically resembling coal, known as K-Fuel. In general, K-Fuel is produced by placing raw material, known as feedstock, into a Koppelman Reactor, where it is dried and carbonized at high temperature and pressure.

This technique was developed by Edward Koppelman (Koppelman). In 1980, the United States Department of Energy (the DOE) awarded to Koppelman a \$ 727,882 grant to study the feasibility of the Koppelman Process. Pursuant to the 1980 grant, Koppelman, SRI International (SRI), the University of Maine, Lehman Brothers Kuhn Loeb Incorporated, Ekono Incorporated, Central Maine Power Company, and Stone and Webster Engineering Corporation (Stone and

Webster) prepared a report (the 1981 report). The 1981 report concluded that the Koppelman Process was technically, environmentally, and economically feasible.

SRI was formed in 1948 at Stanford Research Institute and is a leading research and development organization that provides research and consulting for business and government clients worldwide. Stone and Webster has a reputation as a leader in the engineering field with respect to the construction of large-scale plants.

In 1981, the DOE awarded to A. T. Kearney, an international consulting firm, a \$ 1,603,480 grant for an alternative fuels feasibility study for K-Fuel. Koppelman received a subcontract from A. T. Kearney under the 1981 grant

in the amount of \$ 425,000.

By the summer of 1981, Koppelman, with the assistance of SRI and others, had built a model plant capable of producing K-Fuel in small quantities. The model plant was built at SRI's 70-acre research facility in Menlo Park, California. By this time, the Koppelman Process was covered by various United States and foreign patents.

On March 21, 1984, Koppelman sold a 20-percent undivided interest in the Koppelman Process to DSC Holdings, Inc., a wholly owned subsidiary of Diamond Shamrock Corporation (the Diamond Shamrock Agreement) for \$ 10 million. On the same date Koppelman sold and 80-percent undivided interest in the Koppelman Process to Theodore Venners for \$ 90 million (the Venners Agreement). The

rights transferred by Koppelman pursuant to the Diamond Shamrock Agreement and the Venners Agreement were transferred subject to the rights held by POGA and SFA.

II. The Network

In early 1981, Richard B. Basile (Basile) learned of Koppelman and the Koppelman Process. In March or April of 1981, Basile met with Koppelman. Shortly thereafter, an elaborate network of interrelated entities was formed to exploit the Koppelman Process. POGA and SFA were elements of this network.

Intro-Continental Investment, B. V. (Intro-Continental), owned all of the stock of Ronodo Corporation, N. V. (Ronodo), which, in turn, owned all of the stock of Sci-Teck Licensing Corporation (Sci-Teck). In August 1981

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Koppelman signed a document in which he purported to license Ronodo to produce K-Fuel. Ronodo sublicensed its rights to Sci-Teck, which, in turn, sublicensed its rights to POGA and SFA. On December 31, 1981, POGA and SFA entered into a joint venture to own, operate, and manage a pilot K-Fuel plant. On that date, POGA and SFA entered into separate research and development agreements with Fuel-Teck Research and Development, Inc. (FTRD), under which FTRD agreed to conduct and coordinate the research and development efforts of Koppelman, A. T. Kearney, and others for the benefit of SFA and POGA. FTRD was a wholly owned subsidiary of Petro-Syn Corporation (Petro-Syn).

SFA and POGA also entered into agreements with Chronometer Management & Consultants, Inc. (Chronometer) pursuant

to which Chronometer was to render administrative services to the partnerships. The partnerships' attempt to develop the Koppelman Process was to be partially subsidized by investments in certain oil and gas wells. The partnerships' oil and gas activities were to be conducted by Fuel-Teck Oil and Gas, Inc. (FTOG), another wholly owned subsidiary of Petro-Syn.

A. Koppelman's License to Ronodo

The August 1981 License Agreement purportedly granted Ronodo the exclusive right to use the Koppelman Process in the State of North Carolina to refine wood and peat into K-Fuel. The agreement also purportedly granted Ronodo the exclusive right to use the Koppelman Process in the United States and certain other countries to refine bagasse into K-Fuel. The

agreement explicitly did not grant Ronodo the right to use the process to produce charcoal briquettes for cooking purposes.

In exchange for its rights under the agreement, Ronodo promised to pay a one-time license fee of \$ 4.00 per estimated annual output ton for each Koppelman Reactor. No fee was payable for the first such reactor to be operated by Ronodo. Ronodo also agreed to pay, with certain restrictions and modifications, a 5-percent net royalty on substances produced through the Koppelman Process. Finally, Ronodo agreed to pay additional consideration of \$ 1 million, contingent on the commercial viability of the first Koppelman Reactor. One-third of this amount was allocated to the "Peat License" and two-thirds to the "Bagasse License." The first of two addenda to the

license stated that Ronodo would pay \$ 1,600,000 for a Koppelman Reactor to be assembled by Koppelman in North Carolina. The addendum stated that a "down payment" of \$ 640,000 would be paid by December 1 1981, with a second "down payment" of equal amount to be paid on "April 30, 1981 [sic] and the balance on completion of the reactor's installation.

The License Agreement consisted of 19 typewritten pages and (inserted between pages 9 and 10) three handwritten pages. Each typewritten page contained handwritten changes, additions and deletions, none of which were initialed or otherwise validated. The three handwritten pages, which referred to the additional consideration of \$ 1 million, were unsigned, uninitialed, and not referred to in the typewritten pages. The

agreement bore Koppelman's undated, unwitnessed signature and no other. The first typewritten addendum to the agreement contained uninitialed handwritten alterations and was not signed or dated. The second typewritten addendum was dated and signed by Koppelman and by an "attorney in fact," whose name was illegible, of Ronodo.

B. Sci-Teck's License to SFA and POGA

Ronodo sublicensed its rights under the 1981 License Agreement to Sci-Teck, its wholly owned subsidiary. on December 31, 1981, Sci-Teck entered into separate agreements in which it sublicensed certain rights to SFA and POGA. Sci-Teck's agreement with SFA granted SFA (i) the exclusive right to use the Koppelman process with respect to peat

and wood in certain counties of North Carolina (the SFA Exclusive Area); (ii) the nonexclusive right to use the process at the North Carolina plant with respect to peat; (iii) the nonexclusive right to use the process with respect to peat and wood in the States and Territories of the United States (except the counties of North Carolina not within the SFA Exclusive Area); and (iv) the nonexclusive right to use the process with respect to any material other than bagasse in the States and Territories of the United States. Sci-Teck's agreement with POGA granted POGA the exclusive right to use the Koppelman Process with respect to wood and peat in all North Carolina counties not within the SFA Exclusive area (the POGA Exclusive Area) and other nonexclusive rights identical

to those conferred in Sci-Teck's agreement with SFA.

In their respective agreements with Sci-Teck, SFA and POGA each represented that it was a partnership in the process of making a private offering of between 125 and 250 partnership units. Each partnership agreed to pay Sci-Teck \$ 112,175 for each SFA or POGA partnership unit sold, as follows:

Date Upon	Form	Amt/Unit
Commencement	Cash	\$3,800
	Pntrshp	16,500
	Note Due	
	10/1/2006	
10/1/82	Cash	2,700
	Pntrshp	24,900
	Note Due	
	10/1/2007	
10/1/83	Cash	\$ 3,700
	Pntrshp	33,000
	Note Due	
10/1/2008		
10/1/84	Cash	2,775
	Pntrshp	24,800
	Note Due	
	10/1/2009	
		\$112,175

Each partnership thus agreed to pay between \$ 14,021,875 and \$ 28,043,750 for the rights licensed by Sci-Teck.

In October of 1982, SFA executed a full recourse promissory note payable to Sci-Teck in the amount of \$ 1,805,250 due October 1, 2007. In October of 1982, POGA executed a full recourse 25-year promissory note in the amount of \$ 5,260,125 payable to Sci-Teck.

On its income tax return for 1981, SFA deducted \$ 1,492,050 as a license fee to be paid to Sci-Teck. The amount represented accrual of the note and cash payments due to Sci-Teck on 73.5 units, determined as of the date the 1981 income tax return was prepared. On its income tax return for 1981, POGA deducted \$ 4,288,375 as a license fee to be paid to Sci-Teck. The amount represented accrual

of the note and cash payments due to Sci-Teck on 211.25 units, determined as of the date the 1981 income tax was prepared.

On its 1982 income tax return, SFA deducted \$ 1,980,700 as a license fee. On its 1982 income tax return, POGA deducted \$ 5,830,500 as a license fee. These amounts represented the accrual of the cash and note payments due to Sci-Teck during 1982. For 1982, POGA also deducted \$ 505,897 as interest expense and reported \$ 428,455 as interest income on notes receivable.

C. FTRD

FTRD was created for the purpose of overseeing the construction by Stone and Webster of a Koppelman Process plant. On December 31, 1981, SFA and POGA

separately entered into identical research and development agreements with FTRD. In its agreements with the partnerships, FTRD promised to coordinate the activities of Koppelman, A. T. Kearney, and others for the benefit of SFA and POGA. SFA and POGA each agreed to pay FTRD \$ 29,800 for each SFA or POGA partnership unit sold, as follows:

Date Upon	Form	Amt/Unit
Commencement	Cash	\$ 4,000
	Pntrshp	16,500
	Note Due	
	10/1/2006	
10/1/82	Cash	\$ 1,000
	Pntrshp	8,300
	Note Due	
	10/1/2007	_____
		\$29,800

On its 1981 income tax return, SFA deducted \$ 1,506,750 as a research and development fee paid to FTRD. This amount represented the accrual of the note and cash payments due to FTRD on 73.5 units. On its 1981 income tax return, POGA deducted \$ 4,288,375 as a research and development fee to be paid to FTRD. This

amount represented the accrual of the note and cash payments due to FTRD on 211.25 units, determined as of the date the 1981 tax return was prepared.

On its 1982 income tax return, POGA deducted \$ 1,946,625 as a research and development fee. On its 1982 income tax return, SFA deducted \$ 653,750 as a research and development fee.

D. Chronometer

SFA and POGA each entered into agreements with Chronometer pursuant to which Chronometer agreed to provide management and financial consulting services to the partnerships. For its services, Chronometer was to receive from the partnerships (i) 2 percent of the limited partners' 1981, 1982, 1983, and 1984 capital contributions, (ii) 2

percent of the partnerships' gross income from operations, and (iii) a fixed annual fee of \$ 17,500, adjusted for inflation, plus expenses.

E. SFA and POGA

SFA and POGA issued substantially identical offering memoranda. According to the memoranda, SFA and POGA each offered from 125 to 250 limited partnership interests. The subscription price of \$ 161,500 per interest was payable in cash and promissory notes as follows:

Form	Due	Amount
Cash	On Subscr.	\$ 10,000
Note in principal		
amt \$27,500		
(payable in 3		
installments)	3/1/82	10,000
	3/1/83	10,000
	3/1/84	7,500
Note in principal		
amt \$124,000	3/1/93	24,000
(payable in 5	3/1/94	30,000
installments)	3/1/94	30,000
	3/1/95	30,000
	3/1/2007	10,000
Total		\$161,500

Investors in SFA and POGA also agreed to assume personally a proportionate share of the partnerships' liabilities to FTRD under the research and development

agreements and the liabilities to Sci-Teck under the License Agreements. The Assumption Agreement signed by petitioners was limited to the principal amounts of these liabilities.

The memoranda stated that the partnerships were organized for the following purposes:

To devote a significant portion of initial cash proceeds to a program of developmental oil and gas drilling.

To reinvest a major portion of the early cash flow from initial drilling operations in order to maximize the number of partnership wells.

To exploit new technology by the construction and development of an experimental pilot plant (partially

funded by the Department of Energy) to convert Peat, wood, and other cellulosic materials into a new theoretically clean and efficient synthetic fuel.

Each memorandum set forth tax losses anticipated for the first 4 years of the partnerships' operations. The memoranda contained a complete tax analysis and opinion, assurances of tax representation by Baskin & Sears, and the following caveat:

If an Investor does not, or is not able to, utilize such tax savings profitably, such Investor will not be able to derive the full intended benefit of investment in the Partnership.

The POGA memorandum identified Arthur Goldman (Goldman) as POGA's general partner and described him as follows:

Arthur Goldman. Mr. Goldman is a certified public accountant licensed in the State of New Jersey. Mr. Goldman has been a financial consultant since March 1980 to World Video Corporation, which is engaged in the business of producing video tapes for the medical field. He also is General Partner of Ophthalmology Associates, a limited partnership which manufactures and distributes video cassettes and disks for use by the medical profession. From 1975 to 1980, Mr. Goldman was General Manager and Treasurer of Princeton Electronic Products Inc., which manufactures medical components. During 1974 Mr. Goldman acted as financial consultant to corporations in the telecommunications industry. Prior to 1974 Mr. Goldman was, among other things, General Manager of Plessey

Communication Systems Corp., which manufactured and distributed telephone equipment, and Assistant Controller of Majestic Specialties Inc., a manufacturer of women's clothing.

The SFA memorandum identified Martin Kaye (Kaye) as SFA's general partner and described him as follows:

Martin Kaye. Mr. Kaye is an independent tax and financial consultant. Since January 1979 he has been a consultant to VAS in connection with tax oriented investments. Mr. Kaye is also a consultant to Reliable. During 1978 he served as Vice President and Chief Financial Officer of Dia-Chem International, Ltd., a broker of plasma (human) chemistry control products. Mr. Kaye was a partner of Henry Warner &

Company, a New York certified public accounting firm from 1968 through 1977. Mr. Kaye is a licensed certified public accountant in the States of New York and Illinois and is a member of the New York State Society of Public Accountants and the American Institute of Certified Public Accountants. In addition, Mr. Kaye is Vice President -- Finance and a director of BIS Communications Corporation, which is engaged in providing business information at airport terminals. He also serves as Vice President -- Finance of Goldtex Foods Corporation, a holding company that is engaged through its subsidiaries in retail baking and franchising. Mr. Kaye is a director of Sands Minerals Corporation (Canada) which invests in oil and gas programs.

The memoranda emphasized the difficulties of oil and gas development and the risks associated with research and development. The offering memoranda contained the following caveat:

The value of the Licensed Technology to the Partnership cannot be conclusively demonstrated. The license fee was not negotiated in an arm's-length transaction and it is possible that the Licensed Technology will prove not to have a value to the Partnership commensurate with its cost. Finally, were the title of Ronodo to any of the technology found to be invalid or were any of the patents found to be invalid or unenforceable or found to infringe technology of others, the Partnership would have to seek redress against Sci-Teck which as no significant

assets or Ronodo, which is a foreign corporation with very limited assets and against whom suit might be difficult.

Only 10 percent of the funds contributed to the partnerships was to be allocated to working capital. Almost 70 percent was to be paid to promoters, attorneys, or network entities. According to the memoranda, the proceeds of the offering were to be applied as follows:

<u>Item</u>	<u>During</u> 1981- 1984	<u>Per/Unit %</u> of 1981- 1984	<u>Out of %</u> Long- Term	<u>%</u> of Long-
	<u>Term</u>			
	<u>Notes</u>			
Cash on Comm. & Mark. Fees	\$5,625	15.00%		--%
Mgmt Fee to the Gen Partner	375	1.00		
Org. Exp. Inc. Legal &	1,125	3.00		-

Acctg. Fees

Fees to R & D	5,000	13.33	24,800 20
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License Fee to Sci-Teck	12,975	34.60	99,000 80
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Oil & Gas - Operations	11,275	30.07	--	-
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Mgmt Fee to Consultants	750	2.0	
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Working - Capital	375	1.0	--	-
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Total	37,500	100.00%	\$124,000
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<u>Item</u>	<u>% of Total Unit</u>	<u>Total- Minimum Offering</u>	<u>Total- Maximum Offering</u>
Cash on Comm.& Mark. Fees	3.49%	703,125	\$1,406,250
Mgmt Fee to the Gen Partner	.23	46,875	\$93,750
Org. Exp. Inc. Legal & Acctg. Fees	.70	140,625	281,250
Fees to	18.45	3,725,000	7,450,000

R & D

License Fee to Sci-Teck	69.46	14,021,875	28,043,750
Oil & Gas Operations	6.98	1,409,375	2,818,750
Mgmt Fee to Consultants	.46	93,750	1,870,500
Working Capital nl	.23	46,875	93,750
Total	100.00%	\$20,187,500	\$40,375,000

Interest on the Limited Partners'

Short-Term Notes will be added to Working Capital. This interest is estimated at approximately \$ 28,125 in 1982, \$ 140,625 in 1983 and \$ 189,845 in 1984 if 125 Units are sold and \$ 56,250 in 1982, \$ 281,250 in 1983 and \$ 379,690 in 1984 if all 250 Units are sold. The General Partner will seek to maintain Working Capital at \$ 150,000 and will retain funds whenever it falls below that level

in order to replenish it.

The memoranda stated that up to 85 percent of the net cash flow generated by the oil and gas activities would be utilized to increase oil and gas holdings and to pay off the partnerships' notes to FTRD and Sci-Teck.

SFA prepared an analysis of expected revenues from the partnerships from gas and oil well drilling operations. POGA prepared a similar analysis of the projected revenues from its gas and oil well drilling operations. The projected revenues from gas and oil well drilling would have been sufficient to completely retire the partnerships' notes to Sci-Teck and FTRD both as to principal and interest.

The partnerships did not include financial projections as to the Koppelman

Process in the offering materials because of concerns about applicable securities laws. The memorandum clearly warned, however, that financial success, in terms of K-Fuel development, was highly unlikely. Reasons cited included (1) commercially unproven technology; (2) lack of experience; (3) conflict of interests;; (4) large obligations incurred without arm's-length negotiations; (5) environmental and health problems; (6) severe competition; and (7) inadequate capital (after payments to the promoters and their associates).

III. The Promoters and Their Agents

A. Basile

Basile was a promoter of energy-related limited partnerships. At

some point in 1981, Basile discussed a possible K-Fuel project with Werner Heim of Zurich, Switzerland, with whom Basile had an ongoing relationship. Heim had placed well in excess of \$ 1 million at Basile's disposal for various projects. Thereafter,

Intro-Continental was formed, and for services rendered by Basile, he received a 15-percent interest in Intro-Continental and in its wholly owned subsidiary, Ronodo. In August 1981, Basile became Chairman, Chief Executive Officer and President of Petro-Syn, in which he owned 35 percent of the outstanding stock as of both August 31, 1981, and December 31, 1981. For services to Petro-Syn, Basile was to receive \$ 25,000 annually for 3 years. Basile also was Secretary-Treasurer and Director of

FTRD and of FTOG.

According to the partnership memoranda, Basile's personal interests conflicted with the interests of SFA, POGA and the limited partners. Basile was President and Chief Executive Officer of Genoco Industries, Inc. (Genoco), and a promoter of Petrogene Oil and Gas Associates (Petrogene). The partnership memoranda stated that Genoco would engage in oil and gas activities similar to those engaged in by FTOG, and that Genoco would convert bagasse into synthetic fuel. Petro-Syn, Sci-Teck, Ronodo, Genoco, and Petrogene were all entities in which Basile had a proprietary interest and which stood to profit at the expense of the partnerships. In approximately May 1982, Basile sold his interests in Intro-Continental and

Petro-Syn to Ronodo for \$ 650,000.

B. Gaskell

Keith R. Gaskell (Gaskell) was one of the three principals of Chronometer. In early 1981, as general partner of Petrogene, Gaskell became familiar with the Koppelman Process. Gaskell devoted most of 1981 to the Petrogene project. Gaskell's interest in using the Koppelman Process for his Petrogene project involved bagasse as a fuel stock.

Gaskell had a background in engineering and management. In 1981, Gaskell discussed the Koppelman Process with Koppelman, SRI, Stone & Webster, and the DOE. Gaskell was attracted to the Koppelman Process by its low ash and sulfur content. During 1981 Gaskell believed that energy prices would

continue to rise at a "real rate" of 4 percent. He believed that K-Fuel would be a cost-effective alternative to nuclear power, coal, and wood.

Gaskell employed Compunetics, Inc. (Compunetics), to review the profitability of the Koppelman Process. Compunetics prepared a report (the Compunetics Report) in December of 1981 that concluded that the license fees to be paid to Sci-Teck were "well within the range of normal commercial practice." The Compunetics Report was prepared by Dr. Samuel Hanna, a professor of mathematics and business at Boston University.

The Compunetics Report concluded that, assuming that only one K-Fuel reactor tube were built, all of the notes due to Sci-Teck and FTRD would be fully

paid by 1992. Assuming that one K-Fuel reactor tube were built, the Compunetics Report concluded that the rate of return to a limited partner on a present value basis would be not less than 17 percent. The Compunetics Report concluded that if a 4-reactor tube plant were built, and 250 limited partnership units were sold, the rate of return to the limited partners would be over 55 percent. The report did not examine the validity of its underlying assumptions, i.e., it did not determine whether the construction of a K-Fuel reactor was financially or technically possible. (The Compunetics Report was admitted for nonhearsay purposes only. Petitioners rely on the report to demonstrate that Gaskell took steps consonant with a bona fide profit objective.)

In 1981 Gaskell requested that Lawrence Kurland (Kurland) of Hubbell, Cohen, Stiefel and Gross review all of Koppelman's patents. Kurland was a patent attorney. Kurland reviewed the patents and the file histories of the patents with respect to the K-Fuel process. He concluded that the scope of Koppelman's patents was fairly broad and not restricted in any meaningful way. Kurland advised the partnership that, of the various technologies that he had investigated, the Koppelman Process had the best technological underpinnings. He concluded on the basis of his investigation that investing in the Koppelman Process involved a reasonable technical risk and that it was a sound investment. (Kurland did not testify as an expert witness. Petitioners rely on

his testimony only to demonstrate that Gaskell took steps consonant with a bona fide profit objective.)

C. Rosenthal

According to the partnership memoranda, Peter B. Rosenthal (Rosenthal) was President of World Medical Marketing Corporation which used limited partnerships to produce and market medical video tapes. Rosenthal also was a promoter and a consultant to Genoco. According to the partnership memoranda, in 1975 Rosenthal was convicted under 18 U.S.C. sec. 371 of conspiracy to commit securities fraud. He was fined \$ 10,000, served 4 months and 23 days at Allenwood, Pennsylvania, and was placed on 1-year's probation. Rosenthal was to be employed by Petro-Syn as a consultant. For

services to Petro-Syn, Rosenthal was to receive \$ 25,000 annually. At the time the partnerships were formed, Rosenthal owned 35 percent of the outstanding capital stock of Rosenthal also owned 15 percent of the stock of Intro-Continental and Ronodo, the parent company of Sci-Teck.

D. Aronson

Sometime in 1980, James M. Aronson (Aronson) placed in the Wall Street Journal a situation-wanted ad which came to the attention of Rosenthal. In August 1980, Rosenthal hired Aronson as a full-time employee of World Medical Marketing corporation. Aronson worked for Gaskell, searching for technology usable by Petrogene. At the same time, Aronson worked for Basile, searching out

potential energy projects using the Koppelman Process. Aronson was attracted to the Koppelman Process because it could be used with a variety of feedstocks, as well as by the involvement of A. T. Kearney, SRI, the DOE, and Koppelman. Aronson recommended to the partnerships that North Carolina be chosen as the site to build the K-Fuel demonstration plant based upon North Carolina's favorable climate, the availability of raw materials, and its proximity to coal burning utilities that were regulated by the "Clean Air Act." Ultimately, as the result of "consensus decision" by Basile and others, Aronson was sent to the site of a K-Fuel plant to be constructed in North Carolina "to be in visual contact with what was going on" and to report back to Basile.

In early 1982 Aronson arranged for a site to locate the North Carolina plant and negotiated an agreement to obtain a supply of peat for the operation of the plant. When the plant was under construction, Aronson briefly lived in a tent adjacent to the North Carolina construction site. From 1982 through 1984, Aronson engaged in a variety of projects related to coordinating the construction of the North Carolina plant. The North Carolina plant opened in early 1984.

Aronson had discussions with various potential purchasers of the K-Fuel including Carolina Power and Light. When the price of energy leveled off, Aronson refocused his sales efforts away from the high demand, low margin electric utility market, to the low demand, high profit

charcoal briquette market with the hope of obtaining a profit under changed economic conditions. On July 27, 1983, SFA and POGA were granted the exclusive right to use the Koppelman Process in the State of North Carolina to produce char for use in the manufacture of charcoal briquettes.

Aronson was a stockholder of Petro-Syn. The partnership offering memoranda stated that Aronson was to receive \$ 35,000 annually for services to Petro-Syn. He was also President of FTRD. His annual salary from FTRD initially was \$ 35,000; later it was increased to \$ 50,000. He also received a bonus of between \$ 10,000 and \$ 15,000.

E. Zukerman

In 1981, Michael Zukerman (Zukerman)

was a partner in Baskin & Sears, a New York law firm, specializing in corporate law. Basile, as promoter of the K-Fuel project and a client of Baskin & Sears, brought Zukerman into the project as legal counsel. Zukerman, in turn, brought in Kurland. Zukerman, who had done legal work in a number of similar transactions, regarded himself as being in "the deal business." As such, Zukerman was brought into transactions by a promoter, such as Basile, with whom Zukerman had had a previous relationship. If the deal were not consummated, Zukerman would be paid by the promoter. If it succeeded, Zukerman would become counsel to the partnership and would be paid by the partnership.

Baskin & Sears prepared all promissory notes, contracts, and

assumption agreements to be entered into by SFA, POGA, and their respective limited partners. None of these agreements was entered into at arm's length. Baskin & Sears owned 40 shares, or 4 percent, of the outstanding stock of Petro-Syn. The firm received payments for its services in the SFA/POGA project both from Intro-Continental and from Basile. Although Baskin & Sears looked upon Basile as "the client," the firm also represented Petro-Syn and the Partnerships; the limited partners (investors) were not separately represented.

The "tax group" of Baskin & Sears rendered a tax opinion examining the SFA and POGA offerings and reviewed all pertinent documents to ensure that the transaction complied with section 465.

Zukerman's understanding to the network was as follows:

It had to do with the tax structure, in order to accomplish the desired tax results, you have to have an independent licensor from a contract, and the partnership, in effect -- there was a diagram in the private placement memorandum which directed the cash and knowledge, and the whole concept was to establish an independent contractor, that's where Petro-Syn fell in, and you need an independent licensor. The various other parties around, it, Verrilli, Altschuler & Schwartz was the broker-dealer, Chronometer was the management company, and you had outside contractors. , A.T. Kearny, Stone & Webster, Celas and Peatco. And the the desired tax end.

The Smiths became limited partners in SFA in December of 1981 by purchase of one unit. The Smiths invested in their limited partnership interest in SFA, pursuant to a schedule calling for payments as follows:

Per Unit

\$10,000	Payable upon subscription to SFA
10,000	Due on March 1, 1982
10,000	Due on March 1, 1983
71500	Due on March 1, 1984
24,000	Due on March 1, 1993
30,000	Due on March 1, 1994
30,000	Due on March 1, 1995
30,000	Due on March 1, 1996
10,000	Due on March 1, 2007

\$ 161,500

The Smiths' obligations to SFA were embodied in full recourse promissory notes. The Smiths made timely payments of principal for 1981, 1982, and 1983. Their 1984 principal payment was made in 1985. With Kaye's consent, the Smiths delayed until 1986 the interest payments due in 1982, 1983, and 1984.

On December 30, 1981, the Smiths entered into an agreement with Sci-Teck pursuant to which they agreed to assume personal liability for SFA's obligations to Sci-Teck in the total amount of \$ 99,200. On December 30, 1981, the Smiths entered into an agreement with FTRD pursuant to which they assumed SFA's liability to FTRD in the total amount of \$ 24,800.

In the statutory notice sent to the Smiths, respondent explained his

disallowance of their share of partnership losses as follows:

It is determined that the amounts of \$ 40,392.00 and \$ 388,316.00 shown on your returns for the taxable years 1981 and 1982 as your distributive share of losses from the SYN-FUEL ASSOCIATES partnership are not allowable since it has not been established that the losses were incurred in connection with an activity engaged in for profit or in connection with a trade or business.

It is further determined that your investment in the SYN-FUEL ASSOCIATES partnership is lacking in economic substance other than the avoidance of tax.

It is further determined that no portion of the claimed losses from the

SYN-FUEL ASSOCIATES partnership represents expenditures for research and development under the provisions of section 174 of the Internal Revenue Code of 1954.

Accordingly, your taxable income is increased \$ 40,392.00 and \$ 38,316.00 for the taxable years 1981 and 1982 respectively.

In the alternative, it is determined that - should any portion of the claimed losses from the SYN-FUEL ASSOCIATES partnership be deemed allowable - said allowable portion is limited to the amount which was at risk under the provisions of section 465 of the Internal Revenue Code of 1954 during the taxable year; and that the amount which was at risk does not exceed the amount of your net cash investment in the SYN-FUEL

ASSOCIATES partnership which was paid during the taxable year.

B. Petitioner Karr

Karr and Robert H. Bluhm (Bluhm) became limited partners of POGA in December of 1981 by purchasing one unit as tenants in common. For purposes of this case, Karr will be deemed to have purchased a half unit of POGA. Bluhm is not a party to this proceeding. Because Karr purchased only a half unit of POGA, his liability was as follows:

Per Half Unit

\$5,000 Payable upon subscription to POGA

5,000	Due on	March	11982
5,000	Due on	March	11983
3,750	Due on	March	11984
12,000	Due on	March	11993
15,000	Due on	March	11994
15,000	Due on	March	11995
15,000	Due on	March	11996
5,000	Due on	March	12007

\$ 80,750

Karr's obligations to POGA were embodied in full recourse promissory notes. Karr timely made all of the payments due to POGA between 1981 and 1984 including interest.

On December 29, 1981, Karr entered into an agreement with Sci-Teck whereby he agreed to assume personal liability

for POGA's obligations to Sci-Teck in the total amount of \$ 49,600. On December 29, 1981, Karr entered into an agreement with FTRD whereby he assumed POGA's liability to FTRD in the total amount of \$ 12,400.

In the statutory notice sent to the Karrs, respondent explained his disallowance of their share of partnership losses as follows:

It is determined that the activity in which the partnership was engaged was not entered into for a profit. Accordingly, the income shown on the returns is adjusted in accordance with IRS section 183.

It is determined that the amount of \$ 505,897 shown on your return for 1982 as interest expense is not allowed because

the liability on which it is based is contingent in nature and the notes lack economic substance.

It is determined that the amounts shown are disallowed in full because it has been determined that the partnership activity was not entered into for a profit within the meaning of IRS section 183.

It has been determined that the partnership activity was not engaged in for profit, and accordingly, no investment credit is allowable with respect to any property acquired by the partnership.

V. The Experts

A. Lam

Jeffrey Lam (Lam), petitioners' first expert witness, submitted a report examining the oil and gas investments of

SFA and POGA. Lam is an engineer registered in Texas. He holds a B.S. in Petroleum Engineering from the University of Texas, and he is President of Newington Petroleum consultants, Inc., a firm that appraises oil and gas properties.

In his report, Lam examined the assumptions used by SFA and POGA to calculate the projected production, revenues, and cash flow set forth in the offering memoranda. Lam concluded that the assumptions used by the partnerships were reasonable and consistent with industry practice. He that the projections of production and net revenue set forth in the memoranda were acceptable and reasonable.

B. Pomerantz

Martin L. Pomerantz (Pomerantz), petitioners' second expert witness, submitted a report examining the market potential of K-Fuel slurries. Pomerantz is an engineer registered in Pennsylvania. He holds a Ph.D. in Mechanical Engineering from the University of Pittsburgh, and he is Executive Vice-President of Fuels Utilization Research Institute, a firm that develops co-generation and fuel conversion programs.

In his report, Pomerantz examined slurry fuel technology and boiler retrofit information available in 1981. Based on this information, and in light of 1981 oil price forecasts, Pomerantz concluded that in 1981 it would have been

reasonable to predict a 1985 K-Fuel market of 520,000 tons of K-Fuel per year in North Carolina alone.

C. Plummer and Thomas

James L. Plummer (Plummer) and Thomas C. Thomas (Thomas) prepared the final expert witness report submitted by petitioners. Plummer holds a Ph.D. in econometrics from Cornell University and is the author of numerous books concerning the economics of energy and venture capital formation. Thomas holds a Ph.D. in economics from the Massachusetts Institute of Technology. In their report, Plummer and Thomas examined whether SFA and POGA had reasonable prospects for profitability in 1981. The report also discussed whether the price paid by the

partnerships for licensing the Koppelman Process corresponded to reasonable fair market value.

In determining whether SFA and POGA had reasonable prospects for profitability in 1981, Plummer and Thomas drew upon a wide variety of sources to estimate the capital and operating costs of commercial K-Fuel plants. Plummer and Thomas assumed that the partnerships would not internally finance full-scale commercial operations, but would instead form a joint venture with an electric utility in the region. Relying on a variety of assumptions concerning the division of profits between the partnerships and their joint venture partner, Plummer and Thomas concluded that the partnerships could achieve a pre-tax internal rate of return in excess

of 25 percent. If the K-Fuel were marketed as a component of an oil slurry, the partnerships' rate of return could have exceeded 40 percent. Plummer and Thomas concluded that SFA and POGA had reasonable prospects of profitability in 1981.

In determining whether the price paid by the partnerships for licensing the technology was reasonable, Plummer and Thomas compared the rate of return sought by the partnerships to that sought by Occidental Petroleum in a much larger and riskier shale oil project in Colorado. The report then compared the price paid by the partnerships with that paid by Diamond Shamrock Corporation and Theodore Venners in 1984. Finally, the report compared the price paid by the partnerships to that paid by Ronodo to

Koppelman. The report concluded that the two to one step-up in price from the Ronodo purchase to the purchase by the partnerships was a reasonable cost for the syndication of risk among a large pool of investors. Plummer and Thomas opined that "the agreement between the Limited Partnerships and Sci-Teck was within the range of fair market values."

OPINION

Respondent has conceded that petitioners may deduct their distributive shares of partnership losses attributable to oil and gas investments and may use their distributive shares of any credits attributable to those oil and gas investments. The only deductions in issue, therefore, are the partners' distributive shares of losses represented

by payments to Sci-Teck for license fees and to FTRD for research and development, including interest claimed by POGA and disallowed in the statutory notice sent to the Karrs. The parties agree that the claimed losses are deductible only if incurred in an activity engaged in for profit and, specifically with respect to the research and development expenses, in connection with a trade or business.

Respondent also asserts other grounds for disallowing the deductions to the extent that they are based on notes, rather than cash. The parties disagree about who has the burden of proof on respondent's alternative arguments in the Karrs' case. If, however, we decide that the partnerships, and consequently petitioners, are not entitled to any deductions, we need not reach the grounds

for disallowing deductions not represented by cash payments.

Profit Objective and Economic Substance

Determination of whether an activity is undertaken for profit is generally referred to as involving a "section 183 issue." Section 183 initially served to distinguish between business objectives and personal objectives, but in recent years has been frequently used to compare business objectives with tax objectives. See generally Brannen v. Commissioner, 78 T.C. 471, 506-507 (1982, affd. 722 F.2d 695 (11th Cir. 1984); Jasionowski v. Commissioner, 66 T.C. 312, 321 (1976). In Rose v. Commissioner, 88 T.C. 386, 414 (1987), on appeal (6th Cir., Dec. 14, 1987), we adopted a unified test of

economic substance incorporating factors considered relevant in cases decided under section 183. The Rose approach was a restatement of prior law, particularly identifying objective factors examined under various theories by which respondent challenges the tax treatment of transactions. "Reliance on these objective factors enables us to focus our scrutiny on the actual mechanics of the transactions, rather than on an ephemeral analysis of subjective intentions." Rybak v. Commissioner, 91 T.C._____, slip opinion at 17 (Sept. 7, 1988).

The unified approach of Rose is applicable in cases involving "generic tax shelters," which we there identified as cases having certain characteristics making tax motivation apparent. Those

characteristics are:

(1) Tax benefits were the focus of promotional materials; (2) the investors accepted the terms of purchase without price negotiation; (3) the assets in question consist of packages of purported rights, difficult to value in the abstract and substantially overvalued in relation to tangible property included as part of the package; (4) the tangible assets were acquired or created at a relatively small cost shortly prior to the transactions in question; and (5) the bulk of the consideration was deferred by promissory notes, nonrecourse in form or in substance. ***[88 T.C. at 412]

Once tax motivation is apparent, we must determine "whether sufficient

business purpose existed for the taxpayer to obtain the claimed tax benefits." 88 T.C. at 412.

We also noted in Rose:

We do not rely on or incorporate the definitions of "tax shelter" set forth in sec. 661(b)(2)(C), adopted by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, sec 323(a), 96 Stat. 324 (applicable to returns for which the due date is after Dec. 31, 1982) or sec. 6111(c), added by the Tax Reform Act of 1984, Pub. L. 98-369, sec. 141(a), 98 Stat. 494, 682 (with respect to investments sold after Aug. 31, 1984). Such definitions create "statutory tax shelters." ***[88 T.C. at 407 n. 2.]

Generic tax shelters are distinguishable from statutory tax

shelters (see note 2 supra) and other specific types of tax-preferred activities, such as real property, equipment leasing activities, and oil and gas ventures. See Estate of Baron v. Commissioner, 83 T.C. 542, 552 (1984), affd. 798 F.2d 65 (2d Cir. 1986). [88 T.C. at 413 n. 5.]

After concluding that the arrangement involved in Rose was a generic tax shelter, we analyzed the transaction and determined that it lacked economic substance. We recognized, however, that Congress has created deductions and investment tax credits to encourage certain types of activities, and the taxpayers who engage in those activities are entitled to the attendant benefits. 88 T.C. at 421. See also Fox v. Commissioner, 82 T.C. 1001, 1021 (1984).

The limited partnerships in issue here, with respect to the Koppelman Process activity, have the characteristics generally shared by generic tax shelters. (1) The private placement memoranda emphasized tax benefits, specifically stating that persons not in the maximum tax brackets could not obtain the full advantages of the investment. (2) Petitioners concede that they did not engage in price negotiation. (3) The assets in question, consisting of limited rights to exploit the Koppelman Process in North Carolina, were, according to all of the experts, difficult to value. (4) There were no tangible assets involved, but the partnerships paid a multiple of the price contemporaneously paid by the licensor. (5) The bulk of the consideration was

deferred by promissory notes; although the notes were recourse in form and may have been enforceable, the substantive liability that they represented was far less than the face amount of the notes.

Although these characteristics do not coincide precisely with those involved in Rose, the factors considered in Rose are usefully considered here. Those factors were directly derived from prior cases in which economic substance was examined, including cases in which the result of such examination was to recharacterize a transaction without entirely disregarding it. 88 T.C. at 410-411. See Rybak v. Commissioner, supra. The characteristics attributed to generic tax shelters in Rose merely serve to identify transactions in which tax motivation is apparent. Any doubt that tax motivations

shaped the limited partnership transactions in issue here was dispelled by the testimony of Zukerman, summarized above and quoted at length below.

The oil and gas activities of the partnerships were expressly excluded from the category of generic tax shelters in Rose v. Commissioner, 88 T.C. at 413 n.

5. Such activities are commonly recognized as congressionally encouraged by tax incentives. In any event, respondent has conceded deductions and credits relating to those activities. Thus we cannot conclude that the partnerships totally lacked economic substance. The question remains: What, if anything, was the economic substance of the Koppelman Process activity of the partnerships? Specifically, were these partnerships engaged in the trade or

business of developing energy sources from the Koppelman Process or were they in the business of financing the operations of other entities in exchange for tax benefits?² The business activities of other entities directly involved in exploiting the Koppelman Process will not necessarily be attributed to the limited partnerships in which petitioners invested. See Beck v. Commissioner, 85 T.C. 557, 580 (1985).

Whether we are determining the existence of a profit objective or the status of an activity as a trade-or-business, we examine the appropriate factors at the partnership level. Brannen v. Commissioner, *supra*; Madison Gas and Electric Co. v. Commissioner, 72 T.C.

² See Chung v. Commissioner, T.C. Memo 1986-131.

521, 564-565 (1979, affd. 633 F.2d 512 (7th Cir. 1980). Citing Surloff v. Commissioner, 81 T.C. 210, 233 (1983), petitioners specify that "in determining whether the Partnerships had the requisite profit motive it is necessary to look at the motive and objectives of the promoters and managers of the Partnerships." We do so in detail below.

The Dealings Between the Partnerships and the Other Network Entities

The general partners were tax and financial professionals and had no technical background relevant to exploitation of the Koppelman Process. Neither general partner testified at trial, although Kaye, at least, was present at the commencement of the trial and available to testify. The parties

stipulated that the general partners relied entirely on others to conduct the Koppelman Process activity of the partnerships.

Those others, of course, included Basile, Gaskell, Aronson, and the lawyers who designed the structure of entities and drafted the documentation. The most revealing, and therefore persuasive, evidence of the relationship among the various parts of the network was the candid testimony of Zukerman. See Ewing v. Commissioner, 91 T.C. _____ (Aug. 30, 1988). We therefore quote that testimony at length. Zukerman stated that the structure was chosen to accomplish the desired tax end, as set forth in our findings of fact, page 24 supra. On further examination by petitioners'

counsel, he elaborated as follows:

Q Going back to the structure for a minute, were there any other reasons that this structure was used, other than tax reasons?

A I'm not sure I understand the question. Are you talking specifically about how it was outlined?

Q Well, was there any particular reason why Ronodo was in this transaction?

A *** there were a bunch of projects taking place at that time. There was a substantial amount of money required, and in order to feed, primarily the Petrogene project, it was in excess of \$ 1 million, the -- Richard [Basile] approached some people to put up some money. He had a prior relationship with a man in Zurich

by the name of Werner Heim, who introduced him to the money. And then in exchange for that, -- Richard [Basile] and Peter (Rosenthal) got a percentage interest in the licensor and they retained a substantial interest in the contract of Petro-Syn. And the way it was set up is, Fuel-Teck O&G was to receive substantial sums of money, they got a carried working interest of 12.5 percent and an AFE contract of 15 percent for work done in O&G and they got additional, because they owned an interest in R&D, and the feeling was that there was a substantial amount of money to be made with R&D, their real profit was to be in Petro-Syn and they had a smaller share of what was going to take place in Ronodo.

* * *

Q And these people in Europe are the

ones who provided the \$ 1 million that you talked about?

A Yes, it was in excess of \$ 1 million for the Petrogene project, for the Peat project and for another project they were working on which ultimately didn't go forward.

Q And these people in Europe are the ones who negotiated this particular structure or ---

A No. They were putting up money. They were putting up money and, therefore, they were buying the license and, in effect, taking the true venture capital risk which was to fund these different transactions. And a perfect example is, they funded over \$ 1 million into Petro-Syn -- into Petrogene and it fell apart, no money was ever made. So, they lost way in excess of \$ 1 million on

Petrogene because the deal never went forward. They lost money in Sonic, the transaction never went forward. The only money that was made was in this transaction, and what they did was, they funded it. So that transaction was an independent license agreement, in which this money was funded and there was a tax plan in order to get the license income for the offshore investors.

Then, the domestic operation was set up to, in effect, operate the business because the partnership was passive. So, you had to retain certain people to operate the business. You had the grant, the Department of Energy grant, and the Department of Energy grant there was a number of people involved in that part of the project that would be A. T. Kearny, who was actually granted the grant, Stone

& Webster was one of the contractors, and SRI, who was brought in as a consultant to Ed Koppelman. And that -- so, those people were working on the grant itself.

The Petro-Syn group was to fund the operation. Now, let me, for example, take you through. The concept of the structure was that the investor would go in and take a venture capital risk in the R&D, research and development, but the oil and gas was developmental oil and gas drilling, so, by doing the oil and gas drilling, it was anticipated that the down side would be covered by relatively safe investments in oil and gas. And by constantly reinvesting, the concept was if you reinvested in the oil and gas programs, then you would almost eliminate the risks that would take place in the research and development area.

So, it was set up in such a way that somebody would do it. The experience of the people, there were some substantial -- there was substantial experience at the Petro-Syn level, much more experience than there was in the general partner or in anybody else involved in the project.

Q Going back a minute to the licensor, were there negotiations carried on with these people in Europe as to the license fees that the partnership would carry on and pay and so forth?

A Well, it had to do with the valuation issue. obviously, there were businessmen trying to get as much money as they possibly could. The key ingredient was the return on investment. You had to have a realistic return on -- in other words, when you took the information from Stanford Research

Institute and then you applied mathematical formulas to it, you came up with a return on investment. That return on investment had to fit within certain parameters in order to be a venture capital transaction. If it weren't in the very high ranges, it would not entice people to invest in it. So is the concept of venture capital: You had a high risk with a high reward.

In those times, there were -- you know, all of us were kind of caught up in it. There was a real feeling that we had hit upon some things and it was exciting to be involved in the projects. The Petro-Syn project -- the Petrogene project we all thought was potentially a revolutionary project. The K-Fuel project, although not as revolutionary, had some very, very exciting potential.

And in those days, it was the way to raise money, you couldn't do it in the stock market as easily as you could here. So, when you did a transaction such as this, you had a high risk, high reward transaction.

Petitioners contend that Zukerman's testimony must be considered in the context of what he said during cross-examination, which was:

Q You stated on your direct testimony that part of the reason for structuring the transaction with a foreign corporation was to accommodate certain -- to create certain tax benefits?

A Yes.

Q To create certain tax benefits for whom?

A As far as we were concerned? For the partnership. I'm not sure I understand the question, though.

Q Well, I mean, there was this foreign corporation there and I was wondering whose tax interests were being served by having this offshore corporation.

A In that instance, I would assume the offshore people. In other words, if the people were off shore, they had certain tax goals to accomplish for themselves, I was not involved in their structure. We had a similar structure in Petrogene, they had been advised in that transaction and that structure, that overlay was given to us. All right?

Taking all of this testimony in context, we conclude that the limited partners were to provide cash to finance the

activities of the promoters for their various projects, including notably Petrogene. In return, the investors would get tax benefits.

Relationship Between Fees Paid and Fair Market Value

The license fee paid by the partnerships and the purported research and development fees paid to FTRD, as well as all fees paid for services by the individuals, were based on the number of units in the partnerships sold. This is a very strange way to run a trade or business. Ronodo's agreement with Koppelman, by contrast, called for payments to be made on the basis of actual output. The only expert testimony on the subject of the reasonableness of fees was from petitioners' experts,

Plummer and Thomas, that the price paid for licensing the technology was "within the range of fair market value."

There is no proof of the value of the services performed by FTRD under its agreement. The fees were not set by arm's-length dealing. Basile was asked on examination by petitioners' counsel about the difference in valuation between the license arrangement between Koppelman and Ronodo, on one hand, and between the partnerships and Sci-Teck, a subsidiary of Ronodo, on the other. He explained:

THE WITNESS: On one hand, you-mentioned the value, different valuation or price or cost of the license. In the case of Koppelman to Ronodo, you had pure investment capital, with no guaranteed

return or tremendous risk that was involved, there was absolutely no guarantee whatsoever of any income accruing to Ronodo. Therefore, this was initial seed capital and they were expending tremendous sums of money and could be called upon to expend tremendous sums of money; so, therefore, their risk-to-reward ratio should be commensurately much higher. Once that had been established and all these mechanisms had been put in place, their licensing to the partnership, Ronodo's licensing to the partnership was predicated on the amount of units sold. So, therefore, Ronodo could have conceivably received zero income to many times above that, like a substantial sum of income.

So, therefore, the answer to that is that there should be a difference in

price based on the fact that one was exceedingly risk-oriented, while the other one was based on return of -- you know, return on capital.

On cross-examination, he was asked about the prices set for units in the limited partnerships. His testimony proceeded as follows:

Q Who set those amounts?

A That was with discussions with tax counsel and with people from Ronodo that Mr. Heim had expressed an interest of what he would have liked to have received, and also the fact that what we had computed to be -- to make the project economically viable, that certain amount of -- you know, the funds that would have to be expended to make a viable business project.

Q Was it not the intention that if all of the units being offered were subscribed for, that there would be enough money to pay for all of the leg work and expenses that you had done?

A Yes, sir.

Q What then was the money to be put up by this Swiss entity needed for?

A If the units -- as I mentioned in my earlier testimony, sir, standby capital, if the units did not sell, if it required more exhaustive research or if moneys had to be expended which -- before a sale of a single unit took place, that was pure risk capital. So, as I said, they had agreed to provide standby capital, so that if everything went -- if things went awry, their money was on complete call, similar to, let's say, like a letter of credit, that is, a guarantee against any

losses that everybody would incur.

Obviously, pricing was based on the need for capital from passive investors and not on the value of the license received from Sci-Teck or the services to be performed by FTRD.

The offering materials predicted that of the funds received by the partnerships from 1981 through 1984, approximately 30 percent would be applied to oil and gas operations. Almost 35 percent would be paid to Sci-Tec as license fees and 13.33 percent would be paid to FTRD. Over 20 percent would be paid as commissions and marketing fees, management fees, and organizational expenses including legal and accounting fees. Although the amount left for working capital is small, there is little need for working capital in an

entity that merely takes in and pays out money. This structuring was not necessarily detrimental to the partnership, because it was not required to pay out any more than it took in.

Although the Koppelman Process activity was ultimately a failure, we cannot conclude that the partnership was necessarily doomed to losses from the agreements that it entered into.

Examination of the relationship between the prices paid and fair market value, therefore, does not entirely negate economic substance. It does, however, suggest that the substance was a capital investment partnership rather than an active business to which the license fees and research and development fees were connected.

Structure of the Financing

We frequently compare the face amount of the notes given as consideration with the amount claimed as a current tax deduction to determine the economic reality of the transaction. See Waddell v. Commissioner, 86 T.C. 848, 910-912 (1986), affd. 841 F.2d 264 (9th Cir. 1988); Karme v. Commissioner, 73 T.C. 1163, 1186-1187 (1980), affd. 673 F.2d 1062 (9th Cir. 1982); Golsen v. Commissioner, 54 T.C. 742, 753-754 (1970), affd. 445 F.2d 985 (10th Cir. 1971). Even if there is genuine indebtedness and economic substance to a transaction was cast was inconsistent with its true nature. Packard v. Commissioner, 85 T.C. 397, 419 (1985) .

It appears to us that the deferred nature of the obligations to Sci-Teck and FTRD is indicative of the lack of

substance of those transactions. The evidence does not suggest any business reason why payments for license fees and to fund research and development would be postponed 25 years into the future. By its nature, research and development should be funded as quickly as possible so that the research can be completed and the results put into operation. Until that research and development has been accomplished and the results tested, the rights under the license would be useless. The K-Fuel venture was presented as totally speculative and justified and as meeting an immediate need for energy. A binding agreement to pay substantial and fixed amounts far in the future without regard to the success of this venture simply does not make sense from a business standpoint. Inadequate current

funding would guarantee failure. This structure of financing, therefore, constitutes evidence that the activity was not conducted in a businesslike fashion. See Ferrell v. Commissioner, 90 T.C. 1154, 1185-1190 (1988).

Respondent disallowed the Karrs' proportionate share of interest deducted on POGA's return. The assumption agreements covered principal only. Even assuming that the assumption agreements were valid, there is every reason to believe that the partnership would never have funds available to pay the interest on the notes. The interest, therefore, is too unlikely to be paid to be deducted on an accrual basis. See section 1.461-1(a)(2), Income Tax Regs., and cases cited in Rose v. Commissioner, 88 T.C. at 420-421, 423-424.

Perceived Congressional Intent

The tax benefits purportedly to be obtained with respect to the limited partnerships were predicated on the deductibility, under section 174, of the accrued payments to Sci-Teck and FTRD. For expenses to be deductible under section 174, it is not necessary that they be incurred "in carrying on" a trade or business, as required under section 162. It is only necessary that they be incurred "in connection with" the partnerships' trade or business. The less stringent "in connection with" standard is intended to stimulate the search for new products. Snow v. Commissioner, 416 U.S. 500 (1974).

Petitioners assert "The expenditures by the Partnerships to develop a process which would help to further the national

goal of energy independence and a clean environment was clearly within the purview of Congress' intent." Petitioners then correctly summarize the law and attempt to distinguish the facts in this case from those in cases adverse to the taxpayers as follows:

In Snow the Supreme Court overturned those decisions which had held that research and experimental expenditures by a taxpayer not currently engaged in a trade or business were nondeductible, preopening expenses. Levin v. Commissioner, supra [87 T.C. 698 (1986), affd. 832 F.2d 403 (7th Cir. 1987)]. The Tax Court has held, however, that Snow did not completely eliminate the trade or business requirement. Green v. Commissioner, 83 T.C. 667, 686, 687

(1984). The Court in Green held that in order for an expense to be deductible under Code Section 174 the taxpayer must still be engaged in a trade or business "at some time." As stated in Levin v. Commissioner, supra, the test is, "whether the partnerships were engaged, at any time, in a trade or business in connection with which funds were expended for research and experimentation." In both the Levin and Green cases the Court found that the limited partnerships neither intended, nor were capable of ever engaging in a trade or business. Furthermore, each partnership's role was restricted by design to that of a passive investor.

In Levin v. Commissioner, supra, the Tax Court found that a party other than the partnership had through a series of

contracts "insured that it retained effective control over the development, manufacture, use, and marketing of the machinery [which was the subject of the research and development effort] for its probable commercial life." Likewise in Green, pursuant to a prearranged plan, the partnership would never be able to produce or market the inventions that were the subject of the research and experimental expenditures, and were only entitled to collect royalties due under certain prearranged license agreements.

The present case is clearly distinguishable from Green and Levin. The Partnerships had no agreements, preexisting or otherwise, for the sale or marketing of K-Fuel plants or the rights to build K-Fuel plants. Furthermore, they had no preexisting contracts with any

parties to manufacture K-Fuel plants. Instead, the Partnerships intended to build and finance additional K-Fuel plants, and sell K-Fuel to end users. Thus, unlike the Partnerships in Levin, the Partnerships were not precluded from actively engaging in a trade or business.

Respondent, however quotes the following language from Levin v. Commissioner, 832 F.2d 403 at 406..

The concept of "trade or business" is plastic, [citation omitted], but it hardly follows that anything goes. The taxpayers take a "magic words" approach to the subject: if the partnership's documents contain the right language, then all is well. The Tax Court looked past the documents to the expectations of

the parties at the time. It asked whether the partnerships reasonably anticipated availing themselves of the privileges they possessed on paper. That is the right question; pen and ink divorced from reasonable business expectations do not a "trade or business" make.

Respondent emphasizes criteria from the cases that hold that, for section 174 to apply, the taxpayer must be in a trade or business at some time, even though there is currently neither sales nor production. After analyzing a series of cases including Snow v. Commissioner, 416 U.S. 500 (1974), and citing Levin v. Commissioner, 87 T.C. 698 (1987), affd. 832 F.2d 403 (7th Cir. 1987), the Supreme Court has definitively stated:

We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity does not qualify. [Commissioner v. Groetzinger, 480 U.S. 23, , 107 S.Ct. 980, 987 (1987).]

Passive investment and delegation of business responsibilities to others do not constitute a trade or business, particularly where the conduct of the enterprise and its managers is not businesslike. See Drobny v. Commissioner, 86 T.C. 1326, 1343-1348 (1986).

We are not persuaded by petitioners'

attempt to distinguish this case from Green v. Commissioner, 83 T.C. 667 (1984), and Levin v. Commissioner, supra. Actual control rested in persons whose compensation from these partnerships depended solely on capital contributions, while they had interests in the profitability of competing ventures. The rights of the partnerships to exploit the Koppelman Process in North Carolina are a minute fraction of the rights of the other network members to exploit the Koppelman Process throughout the world. It strains credulity to suggest that their loyalties would flow to the benefit of these partnerships. The offering memoranda cautioned about their conflicts of interest and warned the investors that:

Were the title of Ronodo to any of the technology found to be invalid or were any of the patents found to be invalid or unenforceable or found to infringe technology of others, the Partnership would have to seek redress against Sci-Teck which has no significant assets or Ronodo, which is a foreign corporation with very limited assets and against whom suit might be difficult.

Obviously the partnerships had no effective recourse against or control over their purported agents and licensor.

Comparing, therefore, these facts with the salutary congressional intent reflected in section 174, it seems appropriate to incorporate our comment in Beck v. Commissioner, 85 T.C. 557, 579-580

(1985), that:

In summary, it is apparent that bona fide business enterprises, [presumably those directly involved in developing the Koppelman Process] may find a sideline of marketing tax benefits to provide a useful means of raising venture capital. [See testimony of Zukerman, supra.] To some extent tax incentives, such as [section 174] are designed to stimulate the formation of venture capital. Such incentives are not intended, however, to create a new economy consisting of paper transactions having no relationship to the real value of goods and services. Thus, the mere presence of a valid business enterprise at some levels of a transaction does not automatically entitle passive investors

distant from day-today operation of the enterprise to the associated tax benefits.

Conclusion

Upon consideration of the above factors, we conclude that the partnerships' Koppelman Process activity was not a trade or business, lacked economic substance, and was not within the contemplation of Congress in enacting section 174. The partnerships are not entitled to the deductions claimed.

Section 6659

Because the additions to tax under section 6659 were raised in amended answers, respondent bears the burden of proof as to applicability of the addition to tax for a valuation overstatement. Under section 6659(c), a valuation

overstatement occurs where the claimed value of property or its adjusted basis is 150 percent or more of the value or adjusted basis determined to be correct. The addition to tax applies only to an underpayment attributable to a valuation overstatement. See generally Soriano v. Commissioner, 90 T.C. 44, 61 (1988); Todd v. Commissioner, 89 T.C. 912 (1987), on appeal (5th Cir., Jan. 26, 1988); Zirker v. Commissioner, 87 T.C. 970, 980-981 (1986).

In this case, respondent contends that the underpayments are attributable to valuation overstatements because "there were claims made by the petitioners on their respective income tax returns of adjusted bases in their respective partnership interests which exceeded 300% of the correct amount of such adjusted

basis." Assuming, as the parties do, that an addition to tax under section 6659 may be based on an implied representation of partnership basis when deducting partnership losses, respondent has not satisfied his burden of proof.

First, we are not persuaded that petitioners' assumption agreements may be totally disregarded, although the limitation to principal and the remoteness of payment permitted us to conclude that they did not represent substance consistent with the tax benefits claimed. See Abramson v. Commissioner, 86 T.C. 360, 373-375 (1986); Smith v. Commissioner, 84 T.C. 889, 908 (1985), affd. without published opinion 805 F.2d 1073 (D.C. Cir. 1986). Respondent argues that the agreements are unconscionable and unenforceable under

New York law and are lacking in consideration. Only hindsight, and no evidence existing as of the dates of the transaction, supports these arguments. Second, the only evidence of the likelihood that the notes would be paid was petitioners' expert testimony that they could be paid from operations. Third, respondent has not explained or proven the effect of adjustments to petitioners' bases in their partnership interests that would be made as a result of the oil and gas transactions conceded by respondent.

We have disallowed the research and development and interest deductions in issue because we have concluded that the partnerships were not in a trade or business that would support the deductions claimed, and the Koppelman

Process activity lacked economic substance. See Ferrell v. Commissioner, 90 T.C. 1154 (1988); Zirker v. Commissioner, 877 T.C. at 980-981. Any underpayments thus are not attributable to a valuation overstatement.

Section 6661

With respect to returns filed after December 31, 1982, section 6661(a) imposes an addition to tax on any underpayment attributable to a substantial understatement of income tax. Section 6661(b)(1) defines a substantial understatement of income tax as an understatement exceeding the greater of 10 percent of the tax required to be shown on the return for the year or \$ 5,000. The amount of the understatement is computed in accordance with the

following provisions of section
6661(b)(2)(B) and (C):

(B) Reduction for understatement due to position of taxpayer or disclosed item. -- The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to --

(i) the tax treatment of any item by the taxpayer if there are or was substantial authority for such treatment, or

(ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

(C) Special rules in cases involving

tax shelters. --

(i) In general. -- In the case of any item attributable to a tax shelter --

(I) subparagraph (B)(ii) shall not apply, and

(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

(ii) Tax shelter. -- For purposes of clause (i), the term "tax shelter" means

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement, if the principal purpose of such

partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

As of its effective date, section 6661(b)(2)(C) creates one category of "statutory tax shelters" referred to in Rose v. Commissioner, 88 T.C. at 407 n. 2.

After respondent sent the notices of deficiency involved in these cases, the rate of the addition to tax under section 6661(a) was increased from 10 to 25 percent. See Pallottini v. Commissioner, 90 T.C. 498 (1988). Petitioners Karr assert, and respondent does not dispute, that any addition to tax due from them under section 6661 is limited to 10 percent of the underpayment because respondent has not made claim for the

increased amount.

Petitioners deny that the partnerships are tax shelters within the meaning of section 6661(b)(2)(C). we are satisfied on the record that the principal purpose of the Koppelman Process arrangements between the limited partnerships and the other entities in the network was the avoidance of Federal income tax.

Zukerman's testimony is the primary evidence on this matter. Our analysis of factors leading to the conclusion that the Koppelman Process activity did not have economic substance also supports this conclusion. The understatement, of course, will be reduced from that initially determined by respondent because of his concession of oil and gas related deductions and credits.

Petitioners do not contend that they satisfy the special rule applicable to tax shelters, i.e., that they reasonably believed that the tax treatment of the items in question was more likely than not the proper treatment. They contend that they are entitled to a waiver of the addition to tax under section 6661(c), providing:

(c) Authority to Waive. -- The Secretary may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.

Petitioners claim that respondent abused his discretion because an appeals officer

recommended that the addition to tax not be imposed, but his recommendation was overridden by his supervisors, who gave no consideration to the facts and circumstances applicable to individual partners. Petitioners argue that the addition to tax was determined for an improper purpose, such as "to use as a bargaining chip in subsequent litigation." We cannot infer an improper purpose, however, where, as here, the evidence supports the propriety of imposition of the addition to tax.

Petitioners argue that they relied on a series of accountants and, therefore, had reasonable cause for any understatements of their tax and that they acted in good faith. The tax opinions in the promotional materials of

the partnerships, however, set forth in detail anticipated challenges from the Internal Revenue Service and offered tax assistance. Petitioners' limited testimony was to the effect that they did not read everything. They cannot close their eyes to expressly acknowledged tax risks and then assert that they had "reasonable cause" or "acted in good faith" for an understatement resulting from successful Internal Revenue Service challenge. Because there is no evidence persuading us that petitioners were entitled to a waiver, we need not here examine the limits of respondent's discretion.

Section 6621(c)

Respondent determined that petitioners are liable for additional interest under

section 6621(c) on the ground that petitioners have substantial underpayments attributable to tax-motivated transactions. For purposes of section 6621(c), "tax-motivated transactions" are those described in section 6621(c)(3)(A), including (i) any valuation overstatement, (ii) any loss disallowed by reason of section 465(a), and (v) any sham transaction. As discussed above, we have not concluded that there was a valuation overstatement within the meaning of section 6659(c) or that petitioners' losses are disallowed by reason of section 465(a). We have, however, held that the Koppelman Process activities of the limited partnership were without economic substance and that the principal purpose of the arrangements was tax avoidance. The transactions to

that extent were "sham" within the meaning of section 6621(c)(3)(A)(v).

Patin v. Commissioner, 88 T.C. 1086, 1129 (1987), affd. sub nom. Hatheway v. Commissioner, F.2d (4th Cir., Aug. 23, 1988); see also Cherin v. Commissioner, 89 T.C. 986, 1000 (1987).

Decision will be entered under Rule 155.

APPENDIX C

DEAN B. SMITH and IRMA SMITH,
Petitioners-Appellants, v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee

No. 90-1007

UNITED STATES COURT OF APPEALS FOR THE
SIXTH CIRCUIT

937 F.2d 1089; 1991 U.S. App. LEXIS
13312; 91-2 U.S. Tax
Cas. (CCH) P50,326; 68 A.F.T.R.2d (P-H)
5076

October 9, 1990, Argued June 27, 1991,
Decided June 27, 1991,

COUNSEL: For Petitioner - Appellant,
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Allen, Acting Chief, Mary F. Clark, David
I. Pincus, ARGUED, Kenneth W. Rosenberg,
U.S. Department of Justice,
Appellate Section Tax Division,
Washington, D.C.

JUDGES: Nelson, Circuit Judge; Harry W.
Wellford,* Senior Circuit Judge; and
Charles W. Joiner,**Senior District

Judge. Harry W. Wellford^{*}, Senior Circuit Judge, delivered the opinion of the court, in which Nelson, Circuit Judge, joined. Charles W. Joiner^{**}, Senior District Judge, delivered a separate dissenting opinion.

Appellants, Dean B. Smith and Irma Smith, appeal from the decision of the United States Tax Court concerning deficiencies and penalties imposed upon their federal income tax for 1981 and 1982 by the Commissioner of Internal Revenue. The Tax Court determined that the 1981 and 1982 deficiencies

^{*}The Honorable Harry W. Wellford assumed senior status on January 21, 1991.

^{**}The Honorable Charles W. Joiner, Senior United States District Judge for the Eastern District of Michigan, sitting by designation.

constituted substantial underpayments attributed to a tax-motivated transaction under I.R.C. Sec. 6621 and that petitioners were liable for an additional assessment (in addition to Section 6661). Smith v. Commissioner, 91 T.C. 733 (1988). On this appeal, we must decide: (1) whether the Tax Court correctly determined the taxpayers were not entitled to deduct their allocable shares of partnership losses from the Koppelman Process activities; and (2) whether the Tax Court correctly sustained an addition to petitioners' tax under I.R.C. Sec. 6661 for a substantial understatement of tax and imposed additional interest under Sec. 6621(c) for substantial underpayments attributable to tax-motivated transactions.

The Tax Court decided that appellants were not entitled to deduct a pro rata share of the losses incurred by Syn-Fuel Associates, Ltd. (SFA).¹ The Tax Court determined that the taxpayers were not liable for an addition to tax pursuant to Sec. 6659. In 1989, the Tax Court issued a supplemental opinion concerning the calculation of the amount of the underpayment subject to the addition to tax under I.R.C. Sec. 6661. We have jurisdiction to hear this appeal under 26 U.S.C. Sec. 7482.

In 1981, the Smiths became limited

¹ The Tax Court consolidated this case with a related case in which an appeal was taken to the United States Court of Appeals for the Eleventh Circuit; that court recently affirmed the Tax Court's decision. Karr v. Commissioner, 924 F.2d 1018 (11th Cir. 1991). The Tax Court's opinion refers to both the Smiths and the Karrs, the latter being Georgia residents.

partners in SFA. In 1981, James Karr became a limited partner in Peat Oil and Gas Associates, Ltd. (POGA). SFA and POGA (collectively the "partnerships") were formed for the purpose of (1) engaging in the exploration and development of oil and gas prospects and the acquisition and ownership of gas and oil interests; (2) owning, licensing or otherwise exploiting technology relating to the production of synthetic fuel (K-Fuel) (K-Fuel is a high heating value solid fuel, physically resembling coal, produced by placing wood, peat, lignite and other low grade fossil fuel into a Koppelman Reactor at temperatures and pressures) from peat and other materials; and (3) experimenting with, using, and licensing technology to try to demonstrate the commercial feasibility of

producing synthetic fuel from peat and other cellulosic materials. The idea included the construction, operation, and management of a pilot plant that would attempt to convert peat and other cellulosic material into synthetic fuel for marketing purposes. We set out facts that are found essentially undisputed by the Tax Court. The partnerships entered into a joint venture agreement to own, operate, and manage a North Carolina pilot K-Fuel plant. This is known as the "Koppelman process."

The Koppelman process, reviewed and extensively written about in various technical and industry journals, was developed by Edward Koppelman. In 1980, the United States Department of Energy awarded Koppelman a substantial grant to

study the feasibility of his process. Pursuant to this grant, Koppelman, SRI International (SRI), the University of Maine, a large investment banker, and others, including Ekono, Inc. and Central Maine Power Company, a utility and a large engineering firm, prepared a report concluding that the Koppelman process was "technically, environmentally, and economically feasible." 91 T.C. at 735. SRI is a research and development organization that provides research and consulting for business and government clients worldwide.

In the summer of 1981, Koppelman, together with SRI, completed a model plant capable of producing K-Fuel in small quantities. At the end of 1981, it was believed that the chances of

completing successful construction of a K-Fuel plant were high.

In August 1981, Ronodo Corporation, N.V. (Ronodo) sublicensed from Koppelman the exclusive right to use the Koppelman process within the State of North Carolina to refine and convert peat and wood into K-Fuel. Koppelman also granted Ronodo certain additional rights, all of which were sublicensed by Ronodo to its wholly owned subsidiary Sci-Teck Licensing Corp. (Sci-Teck).

At the end of 1981, the partnerships involving Smith and Karr licensed from Sci-Teck the exclusive rights within the State of North Carolina to use the Koppelman process with respect to peat and wood, as well as the nonexclusive

rights to use the Koppelman process in the remainder of the United States with respect to any material other than bagasse. The partnerships agreed to pay a license fee to Sci-Teck including payment by both cash and notes.

The partnerships also entered into research and development agreements with Fuel-Tech Research and Development (FTRD), which was to conduct and coordinate the research and development efforts of Koppelman, A.T. Kearney, and others, and to oversee the construction by Stone & Webster of a Koppelman process plant. The partnerships agreed to pay FTRD a fee for its services, again through cash and partnership notes. By 1984, a Koppelman process plant had been built in North Carolina.

Taxpayers purchased their one unit partnership interest for \$ 161,500, pursuant to the following schedule of principal amounts:

\$10,000	payable upon subscription to SFA
10,000	due Mar. 1, 1982
10,000	due Mar. 1, 1983
7,500	due Mar. 1, 1984
24,000	due Mar. 1, 1993
30,000	due Mar. 1, 1994
30,000	due Mar. 1, 1995
30,000	due Mar. 1, 1996
10,000	due Mar. 1, 2007

Taxpayers' obligations to SFA were in the form of full recourse promissory notes, and they made timely payments of

principal through 1983. Their 1984 principal payment was not made until 1985. With Martin Kaye's² consent, taxpayers delayed until 1986 the interest payments due in 1982, 1983, and 1984. On December 30, 1981, the taxpayers entered into the described agreements with Sci-Teck and FTRD whereby they agreed to assume personal liability for SFA's obligations in the total amounts of \$ 99,200 and \$ 24,800, respectively.

On their disputed income tax returns for 1981 and 1982, taxpayers deducted \$ 40,392 and \$ 38,316, respectively, representing their distributive share of partnership losses. The Commissioner disallowed these deductions on the ground

² Martin Kaye, the general partner of SFA, is an independent tax and financial consultant.

that it had not been established that the losses were actually incurred in connection with an activity in which the partnership was engaged for profit or with respect to a trade or business. The Commissioner also determined that taxpayers' investment in the partnership lacked economic substance other than the avoidance of tax.

The taxpayers then petitioned the Tax Court to redetermine the proposed tax deficiency. Their case was selected as one of two test cases involving the SFA and POGA partnerships. Following a week-long trial, the Commissioner conceded that the taxpayers could deduct their distributive shares of partnership losses attributable to oil and gas investments. The Tax Court opinion, which

we review, addressed the partners' distributive shares of losses represented by payments to Sci-Teck for license fees and to FTRD for research and development. The Tax Court held that the partnerships were not entitled to the claimed deductions. Citing Rose v. Commissioner, 88 T.C. 386, 414 (1987), aff'd, 868 F.2d 851 (6th Cir. 1989), the Tax Court determined that tax motivations shaped the limited partnership transactions in question and that Koppelman Process activities lacked economic substance apart from the anticipated tax benefits.³ The Tax Court, moreover, determined that

³ Because the Tax Court found that the partnerships' Koppelman process activities lacked economic substance, it did not reach the other grounds for disallowance of a portion of the deduction as asserted by the Commissioner based on I.R.C. Sec. 465. 91 T.C. at 750, 753.

such activities were not "in connection" with the partnerships' trade or business under I.R.C. Sec. 174.

The Commissioner conceded that taxpayers may deduct their distributive shares of partnership losses attributable to oil and gas investments and may use their distributive shares of any credits attributable thereto. The only deductions in issue, then, are the distributive shares of losses represented by partnership payments to Sci-Teck for license fees and to FTRD for research and development. There is no dispute but that the claimed losses to be deducted must have been incurred in an activity in which taxpayers engaged for profit, and with respect to the research and development expenses, the losses must

have been incurred in connection with a trade or business.

The Tax Court noted that ten percent of contributed funds to the various related partnerships was to go to working capital while seventy percent was to go to "promotions, attorneys, or network entities." The offering memorandum, however, provided that interest on the limited partners' short-term notes was to be added to working capital, estimated at \$ 28,125 in 1982, \$ 140,625 in 1983, and about \$ 190,000 in 1984. Only 125 units (one-half of the total proposed) were sold. Working capital was to be maintained at \$ 150,000. The opinion also noted that "up to 85 percent of the net cash flow generated by the oil and gas activities would be utilized to increase

oil and gas holdings and to pay off the partnerships notes to FTRD (the entity created to oversee construction) and Sci-Teck." Analyses prepared by SFA and POGA, the Tax Court conceded, indicated that "projected revenues from oil and gas drilling would have been sufficient to completely retire the partnerships notes to Sci-Teck and FTRD. The same offering memorandum warned that financial success of K-Fuel development was "highly unlikely" for a number of particularized reasons, including "inadequate capital," "conflict of interests" and "commercially improved technology."

An outside firm found the significant amount of license fees to be paid to Sci-Teck to be "well within the range of normal commercial practice."

This conclusion was based upon a report by a purported academic expert, which also indicated a profit to investors if one K-Fuel reactor tube was successfully constructed and became operable. A patent attorney gave an opinion that Koppelman's patents seemed valid and that the Koppelman process had better "technological underpinnings" than others he had investigated. This attorney, Lawrence Kurland, concluded that this potential process "involved a reasonable technical risk" and was a "sound investment." one of the promoters or supervisors of the North Carolina plant, James Oronson, secured rights to use the Koppelman process "to produce char for . . . charcoal briquettes." A New York law firm, purportedly involved in legal work in "a number of similar transactions"

rendered a tax opinion on the organizational structure of the partnership involved and described it as "a tax structure to accomplish the desired tax end."

An expert witness in the oil and gas field, Jeffrey Lau, concluded that the assumptions used by the partnerships were reasonable and consistent with industry practice "with respect to projections and assumptions" of oil revenues and cash flows. Dr. Martin Pomerantz, an engineer expert, and an executive in a fuel conversion business, concluded "that in 1981 it would have been reasonable to predict a 1985 K-Fuel market of 520,000 tons." Two other economist academic experts, were of the opinion that the partnerships might achieve a reasonable

return on investment "and had reasonable prospects of profitability in 1981, and that the price to be paid to Sci-Teck "was within the range of fair market value."

I.R.C. Section 183 considerations

The "general rule" as to actions covered by this section of the Internal Revenue Code dealing with "activities not engaged in for profit" is that "no deduction attributable to such activity shall be allowed" unless otherwise allowable under Sec. 162⁴ or Sec. 212(1)

⁴ Section 162 deals with "trade or business expenses", which are limited to "ordinary and necessary expenses paid or incurred . . . in carrying on any trade of business."

or (2).⁵ Under Sec. 183, an activity is engaged in for profit if the taxpayer entertained an actual and honest, even though "unreasonable or "unrealistic", profit objective by engaging in the activity. Treas. Reg. Sec. 1.183-2(a) cited in Campbell v. Commissioner, 868 F.2d 833, 836 (6th Cir. 1989). Campbell instructs that nine relevant factors are to be examined in making this determination.⁶ In disallowing expenses

⁵ Section 212 deals with "expenses for production of income" or "management, conservation or maintenance of property held for the production of income."

⁶ The factors are:

- (1) the manner in which the taxpayer carried on the activity;
- (2) the expertise of the taxpayer or his advisors;
- (3) the time and effort expended by the taxpayer in carrying on the activity;
- (4) the expectation that assets used in the activity may appreciate in value;
- (5) the success of the taxpayer in carrying on similar or dissimilar

or deductions relating to the Koppelman process or K-Fuel development under this section, the Tax Court relied heavily upon Rose v. Commissioner, 88 T.C. 386 (1987), aff'd, 868 F.2d 851 (6th Cir. 1989) (decided by this court after the Tax Court decision in controversy). Rose involved a purchase by taxpayers of "reproduction masters" of Picasso originals while operating as Lecea Arts and claims by taxpayers of investment tax credits, depreciation, interest expense attributable to the disputed purchase. In

activities;

- (6) the taxpayer's history of income or loss with respect to the activity;
- (7) the amount of occasional profit, if any, which is earned;
- (8) the financial status of the taxpayer; and
- (9) whether the elements of personal pleasure or recreation are involved.

Treas. Reg. Sec. 1-183-2(b).

Rose, the taxpayers made the purchase "without investigation of the highly sophisticated art market," and without "any independent appraisals" of value, and the "reproductions . . . had no proven market or marketability." 868 F.2d at 852. (The court noted that the "fair market value" in the tax years at issue "was negligible." Id.). There was no income realized from any claimed trade or business in the years in question. Admittedly, tax considerations played a "substantial role" in the purchases of what was treated as a "tax shelter" in Rose. Id.

Taxpayers in Rose plunged into an unknown area, "and neither sought nor received information on how to exploit commercially" the reproductions obtained

for an inflated price of more than one million dollars. Id. Accordingly, the Tax Court in Rose held that "the [taxpayers] did not have an actual and honest profit objective in acquiring the Picasso packages, and the transactions were devoid of economic substance." Id. at 854. We upheld the Tax Court findings that the activity in question did not constitute a "trade or business" under I.R.C. Sec. 162. We adopted the test in Rose of "whether the transaction had any practicable economic effect other than the creation of tax losses." Id. Since the Tax Court findings in Rose were not clearly erroneous, and its "analysis" was "correct," we affirmed the holding that the transaction was essentially a "sham" with "no honest profit motive." Id. citing Mahoney v. Commissioner, 808 F.2d

1219, 1220 (6th Cir. 1987).

In Rose, however, we did not adopt the "generic tax shelter test," which was discussed at considerable length by the Tax Court in the instant case. Id. at 853. The concerns of the Tax Court were (1) emphasis upon tax benefits; (2) no price negotiation; (3) difficulty of valuation; (4) payment of twice the price paid by the seller licensor for limited Koppelman process rights; and (5) deferral of payment. In addition to Rose, the Tax Court emphasized the testimony of Michael Zukerman, tax counsel involved. The Tax Court conceded that the business partnership here, unlike the purported Rose business entity, did not lack economic substance, at least in part.

Zukerman testified that the complex financial structure was utilized to accomplish favorable tax ends. European investors committed over one million dollars for a Petrogene project and for "the Peat project" and another that did not go forward. These investors, who had a conflict of interest, to some extent, with the partnerships involved, were, according to Zukerman, "buying the [Koppelman] license." In connection with their risk, (and, coincidentally, that of the taxpayers and the limited partnerships) "it was anticipated that the down side would be covered by reactively safe investments in oil and gas . . . [and] almost eliminate the risks that would take place in the

research and development area."⁷ In sum, the Tax Court concluded from the Zukerman testimony "that the limited partners were to provide cash to finance the activities of the promoters for their various projects, including notably Petrogene."

The Tax Court was struck by the fact that the amount of fees in this arrangement for services (for license and for research and development) were dependent upon the number of partnership units sold, "a very strange way to run a trade or business." The experts produced by the Smiths justified this practice, and the increase in price paid for the Koppelman process license, because the

⁷ Zukerman added that "you had a high risk with a high reward. . . . The K-Fuel project, although not as revolutionary [as the Petrogene project] had some very, very exciting potential."

carrying out of the K-Fuel project "was exceedingly risk-oriented."

We are not as impressed as the Tax Court judge was with this purportedly unusual method of procedure, or contingent arrangement, because many times promoters, salespersons, or professionals, such as attorneys or brokers or engineers, may receive a greater or lesser fee based upon success of the venture or undertaking involved. We interpret Zukerman's testimony, on the other hand, as indicating that European investors or promoters put up front end money or "pure risk capital" to acquire the license and to do initial research on feasibility "before a sale of a single unit took place," and that a sale of the license or process to the partnerships

would call for an amount "to make the project economically viable" for the initial promoters and developers of the Koppelman process, who invested original substantial sums at risk in the hope it would produce a satisfactory return.

The Tax Court conceded in its opinion that, despite the complex and unusual nature of the over-all transaction, the structuring was not necessarily detrimental to the partnership, because it was not required to pay out any more than it took in, therefore characterizing the partnership in controversy as a "capital investment partnership rather than an active business to which the license fees and research and development fees were committed." We do not agree that this is

a correct characterization; we conclude, rather, that the partnerships were risk venture operations carrying on a trade or business within the meaning of the tax laws.

The Tax Court challenged the substance of the fee and license payments because the payments were contingent in size or amount and because the obligation to pay involved a long term obligation. The Tax Court cited Ferrell v. Commissioner, 90 T.C. 1154 (1988) in support of its holding that such an extended payment did "not make sense from a business standpoint." Ferrell, however, involved very large multi-million notes, not installment notes, due in approximately twenty years to an entity which had "no capital or

other funds with which to finance the acquisition of leases" needed purportedly to put the oil and gas venture into operation. The notes involved in Ferrell were many times more in amount than the actual cash value of leases to be acquired, and a substantial proportion were executed in Ferrell, when much of the program of leases for which it represented payment had already been abandoned. Also, the notes were interpreted to provide for non-recourse simple interest payable in some twenty years, and there was a "prearranged" release of individual taxpayer investors from their personal assumption of liability. 90 T.C. at 1188. Ferrell did indeed involve "bizarre behavior" in a "tax shelter facade . . . [with] never any intention to enforce [the notes] and

assumption agreements." Id. at 1189.

We are mindful of the considerable differences between the Ferrell and Smith arrangements. Two promoters in Ferrell, "neither one of whom had any oil and gas business experience," siphoned off 65% of the anticipated gross receipts of the entity involved in the face amount of \$ 118,000,000 in long term non-recourse notes. 90 T.C. at 1188. The notes "almost certainly would not be paid" in Ferrell, whereas here the recourse installment notes were, in fact, paid by investors over a course of years. Id. at 1186. In Ferrell, the leases assigned to the taxpayer partnership were not only paid for, but, in addition, the Ferrell investors agreed to pay "multi-million-dollar notes" "having no

relationship to economic reality." Id. at 1186, 1187 (emphasis added). Like the situation in Ferrell, the amount of the notes at issue were keyed to the amount of cash to be invested by the limited partners rather than the value of the leases, but approximately \$ 80,000,000 of notes were executed in Ferrell after 62% of the proposed oil and gas program had been abandoned, and interest on the notes was deferred for some 20 years. The entity to be paid the huge amount of money in Ferrell clearly had no experience or means to give practical assistance in oil operations. We are persuaded that while there were some similarities between Ferrell and the instant controversy concerning tax shelter arrangements, the substantial differences in the cases render Ferrell

distinguishable.

We deem the situation here to be more akin to that in Pritchett v. Commissioner, 827 F.2d 644 (9th Cir. 1987) where the limited partner's proportionate share of liability on recourse notes on an oil and gas venture were held to be deductible for tax purposes. See Melvin v. Commissioner, 88 T.C. 63, 75 (1987) (limited partners who remain in "chain of liability" and have ultimate economic responsibility for the loan, payable in future years, may deduct payments), aff'd, 894 F.2d 1072 (9th Cir. 1990). It should be noted also that oil and gas revenues from the partnerships in this case were expected to retire the partnership notes to Sci-Teck and FTRD so that not all of the taxpayers' payments

were expected to be needed at the outset. We thus view the arrangement as not devoid of any business rationale or economic reality. We conclude, therefore, that the payments at issue were part of a transaction engaged in for ultimate hope of profit, and were incurred in carrying on a partnership trade or business within the meaning of I.R.C. Secs. 183 and 162. We also conclude that principal and interest payments by the Smiths were intended as expenditures for production of income within the meaning of I.R.C. Sec. 212.⁸ The transaction and

⁸ "Section 162(a) allows deductions for professional and consulting fees, and travel and other miscellaneous expenses only if they are ordinary and necessary expenses incurred in trade or business." Hayden v. Commissioner, 889 F.2d 1548, 1552 (6th Cir. 1989). "Section 212 allows a deduction for such expenses only if they are paid or incurred for the production of income." Id.

investment, including execution of recourse notes, had "practicable income effects other than the creation of income tax losses." Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989).

The standard of review to be applied in review of findings of fact of the Tax Court is whether such findings are clearly erroneous. Ratliff v. Commissioner, 865 F.2d 97, 98 (6th Cir. 1989); Ohio Teamsters Educational and Safety Training Trust Fund v. Commissioner, 692 F.2d 432, 435 (6th Cir. 1982). On the other hand, the legal standard applied by the Tax Court and its legal conclusions based upon its findings of fact are reviewed de novo. Ratliff, 865 F.2d at 98.

In its factual aspect, the Tax Court's conclusion that the transactions in question lacked economic substance leaves us "with the definite and firm conviction that a mistake has been committed." Anderson v. Bessemer City, 470 U.S. 546, 573 (1985) (quoting United States v. United States Gypsum Co., 333 U.S. 364, 395 (1948)). We recognize that this result is at odds with the Eleventh Circuit's decision in Karr (see note 1, supra), but under the law of this circuit the proper test is "whether the transaction has any practicable effects other than the creation of income tax losses." Rose, 868 F.2d at 853 (emphasis supplied). It is crucial, moreover, that this inquiry be conducted from the vantage point of the taxpayer at the time the transactions occurred, rather than

with the benefit of hindsight. Hayden,
889 F.2d at 1554-56 (Nelson, J.,
dissenting); Treas Reg. Sec. 1.183-2(a).

The evidence presented at trial included the following: a report concluding that the Koppelman process was "technically, environmentally, and economically feasible;" a showing that the taxpayers' obligations to SFA took the form of full recourse notes; financial analyses indicating that projected revenues would be sufficient to retire the partnership's notes to FTRD and Sci-Teck; and uncontradicted expert testimony stating that the Koppelman process did have a reasonable chance of generating profits. These investments were risky, to be sure, and the taxpayers were predictably concerned about saving

taxes--but the question is whether, apart from the anticipated tax advantages, the taxpayers' investment was a sham. on the basis of the evidence presented, it seems obvious to us that the investment was not a sham.

We are supported in our conclusion by our recent decision in Bryant v. Commissioner, 928 F.2d 745, (6th Cir., 1991), in which we reversed the Tax Court under circumstances similar in many respects to those present here. Bryant also involved a speculative venture which produced a claim of large tax losses by the investors, the Commissioner disallowing on the basis of a Sec. 183 determination that it was a sham transaction. First we considered in Bryant the question as to whether a fully

enforceable recourse note not contingent on the profitability of the venture was a legitimate basis for deduction under Sec. 616(a) of the Code. (It was.) We next concluded in Bryant that "we review de novo the legal standard applied in determining whether or not a transaction is a sham." Id. at 748, citing Rose v. Commissioner, supra.

The standard to apply was then set out [I]n determining whether a transaction was a sham, the court should not address whether, in the light of hindsight, the taxpayer made a wise investment, as did the trial court here. Instead, the court must address whether the taxpayer made a bona fide investment at all or whether he merely purchased tax

deductions.

Id. at 749.

We reversed the Tax Court on the sham inquiry citing legislative history to Sec. 183:

[i]n determining whether losses from an activity are to be allowed, the focus is to be on whether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit. This will prevent the rule from being applicable to situations where many would consider that it is not reasonable to expect an activity to result in a profit even though the evidence available indicates

that the activity is actually engaged in for profit. For example, it might be argued that there was not a "reasonable expectation of profit in the case of a bona fide inventor or a person who invests in a wildcat oil well.

Id., quoting S. Rep. No. 552, 91st Cong., 1st Sess., reprinted in 1969 U.S. Code Cong. & Admin. News 1645, 2027, 2133-34.

The conclusion in Bryant was similar to the one we reach in this case--"a reasonable expectation of profit [subjectively] is not to be required;" rather we look to whether "the taxpayer entered the activity, or continued the activity, with the objective of making a profit . . . even though the expectation

of profit might be considered unreasonable." Id. at 750 (emphasis added) quoting S. Rep. No. 552, supra. Here, as in Bryant, we conclude that the Tax Court was in error in questioning the transaction on the basis of whether it "was likely to be profitable." Id.

I.R.C. Section 174

For expenses to be deductible under this section providing deductions for research and experimental expenditures, they must be incurred also "in connection with" the partnership trade or business, a less stringent requirement than "carrying on" a trade or business. Because expenses under section 174 are intended to stimulate new products and processes, such as energy development,

taxpayers argue that they fulfill this requirement of this section. The provisions of section 174(a)(1) "apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor)." Sec. 1.174-2(a)(2), Income Tax Regs.

Green v. Commissioner, 83 T.C. 667, 684 (1984).

In Snow v. Commissioner, 416 U.S. 500 (1974), the Supreme Court, construing Sec. 174, held that a partnership formed

to develop an unpatented trash-burning device, even though no sales of product were made in the years in question, could deduct expenses for developing the new product under Sec. 174. "The taxpayer must still be engaged in a trade or business at some time," however, to qualify for Sec. 174 treatment. Green, 83 T.C. at 686. We conclude that the claimed deductions (and those of the partnership) do qualify under Sec. 174 since they "are sufficiently substantial and regular to constitute a trade or business." Id. at 687. See also Levin v. Commissioner, 87 T.C. 698 (1986), aff'd, 832 F.2d 403 (6th Cir. 1987). We cannot say that the Koppelman process activity lacked economic substance or that it was not an effort in research and experimentation within the intention of Sec. 174.

Snow made it clear that "Section 174 was enacted in 1954 to dilute some of the conception of 'ordinary and necessary' business expenses under Sec. 162(a)." Id. at 502. Snow interpreted "in connection with" as used in Sec. 174 to be broader than the term "in carrying on any trade or business" as used in Sec. 162. Id. at 503.⁹ We deem the kind of enterprise to develop the Koppelman process and K-Fuel reactors as a type of "small" and "upcoming" partnership enterprise encouraged in Snow. Id. at 504. Since we

⁹ "[S]ince the decision in Snow, a taxpayer need not be engaged in a trade or business at the time of expenditure in order to qualify for a deduction under section 174(a)(1), because that provision was intended to encourage high technology start-up ventures. . . 'the taxpayer must still be engaged in a trade or business at some time. . . .' Green v. Commissioner, 83 T.C. 667, 686 (1986) (emphasis in original)." Diamond v. Commissioner of Int. Rev., No. 89-2817 (4th Cir. 1991).

find evidence of a profit motive in the development of the Koppelman process at issue, we conclude that Snow is applicable here.¹⁰ The Tax Court found that the partnership in question, SFA,, was making an "attempt to develop the Koppelman process." 91 T.C. at 736. SFA had an "exclusive right" in its limited development in North Carolina. It also purported to engage in "oil and gas drilling" and "to exploit new technology . to convert peat [and] wood . . . into a new . . . clean and efficient synthetic fuel." Id. at 741. Kaye was engaged as consultant, a CPA, with varied business experience and a director in another oil and gas investor entity, and the K-Fuel

¹⁰ Our court affirmed the Tax Court in Snow in disallowing the claimed deductions as not "in connection with a trade or business." The Supreme Court reversed for the reasons indicated.

development was described as "commercially unproven technology [with potential] environmental and health problems [and] inadequate capital." Id. at 743. Zukerman, who was paid as counsel in arranging the transaction by outside promoters not connected with SFA, formulated the agreements and tax structure designed to maximize tax deductions to SFA and investors such as Smith.

We conclude, despite the deferred nature of license and partnership payments, despite the high percentage of receipts going to promoters, attorneys, and developers, and despite the contingent and problematical nature of the operation, and the high risks involved, that the partnership

activities, through a number of agents and outside managers and consultants, were sufficiently "substantial and regular" to constitute a trade or business for purposes of Sec. 174. See Green, 83 T.C. at 687. The activities involved a risk-filled hope and design to develop a new energy source or process. Experts testified that oil and gas assumptions and projections of SFA were reasonable. other experts pronounced it reasonable to expect substantial production and sale of K-Fuel in North Carolina and that SFA "had reasonable prospects of profitability." Smith, 91 T.C. at 752.

The issues in this case are close as evidenced by the position of the dissent and the differing views of another

circuit on similar facts. We readily recognize that such issues may invite different viewpoints on deductibility of the losses here involved especially as to the project's commercial feasibility. We must simply disagree with the characterization of the dissent that taxpayer's experts' testimony about "commercial viability" were of "negligible value" in distinction to what was "centered" on "technical viability of the Koppelman process."¹¹ We must also respectfully disagree that the "taxpayers' outlay for this venture was minimal."

¹¹ The dissent seems to concede that such testimony did address "the surface question of the economic potential of the partnerships' activities." (Emphasis added).

We conclude, in any event, that the taxpayers claimed interest paid on the notes to FTRD and Sci-Teck are deductible. Rice's Toyota World v. Commissioner of Internal Revenue, 752 F.2d 89 (4th Cir. 1985), held that even in the case of a sham transaction entered into primarily for tax benefit purposes, a taxpayers' payment of interest on a recourse note made in connection with a no profit motive arrangement was deductible. The recourse note in the instant case, as in Rice's Toyota World, was a "genuine obligation, and involved "something of economic value." Such recourse notes interest is deductible even in the face of the sham nature of the underlying agreement.

To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.

Id. at 91.

We find it error to have concluded on the facts and record that the Smiths , were motivated by "no business purposes" and that the transaction in controversy had "no economic substance" nor any "reasonable possibility of a profit."

The Commissioner and the Tax Court

were correct in examining the complex arrangement in this case carefully and with skepticism given the totality of circumstances. We believe, however, that the claimed deductions, including interest, considered under each of the code sections analyzed, do authorize a deduction as claimed subject to further examination and limitation under I.R.C. Sec. 465. We, accordingly, REVERSE the Tax Court's disallowance under the above sections and its decision that SFA was a "generic tax shelter" rather than a "statutory tax shelter." Id. at 754.

Section 6661 Considerations

Section 6661(b)(1) defines a substantial understatement of income tax as an understatement

exceeding the greater of 10 percent of the tax required to be shown on the return for the year or \$ 5,000.00.

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As of its effective date, section 661(b)(2)(C) creates one category of "statutory tax shelters" referred to in Rose v. Commissioner, 88 T.C. at 407 n.2

Smith, 91 T.C. 733, 766, 767.

The Tax Court found that, based primarily on the Zukerman testimony, "the principal purpose of the Koppelman Process arrangements between the limited

partnerships and the other entities in the network was the avoidance of Federal income tax." Id. at 767-68. Taxpayers claim that they acted in good faith, although taking substantial tax deductions was, no doubt, a part of the anticipated arrangement. Based on our conclusion that the deductions were improperly disallowed, we need not pause further to discuss the Sec. 6661 penalty. our conclusion on the basic deductibility of the partnership claims settles it that no Sec. 6661 penalty may attach. Our decision requires the same result as to the added Sec. 6621(c) assessment.

We REVERSE the decision of the Tax Court, accordingly, and REMAND for consideration of the alternative I.R.C. Sec. 465 contention of the Commissioner

in this case.

CHARLES W. JOINER, Senior District Judge, dissenting. I respectfully dissent from the majority opinion. Whether the partnerships were engaged in a trade or business, and whether the taxpayers entered into the transaction with a profit motive, are questions of fact, on which the Tax Court must be sustained unless its holdings were clearly erroneous. Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989). Notwithstanding that the Tax Court utilized the "generic tax shelter" inquiry disapproved of in Rose, here, as in Rose, its use of this test is not controlling. The Tax Court went on to address the appropriate questions for our purposes, and its conclusions based upon those inquiries

are not clearly erroneous. The decision should be affirmed.¹²

In Campbell v. Commissioner, 868 F.2d 833, 836 (6th Cir. 1989), we noted that Treasury Regulations section 1.183-2(b)(1)-(9) lists nine factors used in evaluating whether a transaction has been entered into with a profit motive. These factors are not exclusive. They are prefaced in the regulations with:

In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is

¹² Karr v. Commissioner, 924 F.2d 1018 (11th Cir. 1991), the appeal from a case that was consolidated with this case in the Tax Court, reaches the same conclusion.

determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. . . .

Treas. Reg. Sec. 1.183-2(b).

Those of the listed factors which apply to the present situation favor the resolution reached by the Tax Court. The first of the factors is the manner in

which the taxpayer carries on the activity. This inquiry is further explained by the regulations as follows:

The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may

also indicate a profit motive.

Treas. Reg. Sec. 1.183-2(b)(1). In this case, the record-keeping of the venture was so poor that the taxpayers were unable to produce a valid draft of the license agreement by which Ronodo derived the technology which is the heart of this venture from its inventor, making it impossible for the Tax Court to evaluate the relative value of the license in the hands of Ronodo and the partnerships. The agreement which was offered in evidence had handwritten amendments scrawled throughout, and included three addenda, one of which was also handwritten. The only paper among these which bore the signature of both the licensor and licensee was one of the addenda. The degree to which this venture was

undercapitalized also distinguishes it from the normal business setting. The controllers of the venture only committed to fund each partnership with working capital of \$ 150,000 per year. Further, had the partnerships been fully subscribed (half of the partnership units were actually sold), only \$ 1,250,000 was to be invested in research and development in the first 23 years of the venture. Approximately 80 percent of the payments for research and development were not scheduled to be tendered until the year 2006. Lastly, the partnerships did not take steps to alter the conduct of the business in the face of the North Carolina plant's difficulties with efficiencies of scale. As if to underscore the sham nature of this transaction, one tiny plant was planned,

one tiny plant was built and produced a token few pounds of fuel, and there was evidence of only cursory attempts to find an actual market for the product, after the plant was under construction. Given that use of the K-fuel, as the Tax Court noted, would require modification of the users' facilities, the taxpayers' arguments going to the projected cost of producing K-fuel as compared to other fuels do not conclude the inquiry into whether they carried out reasonable investigation, before and during the venture, as to the process' commercial viability, because the product's users would be required to make additional expenditures. The minimal and belated efforts to identify and secure purchasers for this fuel in advance are completely inexplicable under ordinary business

practice.

The second factor, the expertise of the partnership or its advisors, is discussed in the regulations as follows:

Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to

derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

Treas. Reg. Sec. 1.183-2(b)(2). While the partnership's activities were allegedly carried out with assistance and input from the inventor of the process himself, and, therefore, it can be presumed that the partnership had expert technical advice, the feasibility of this venture as a commercial activity appears to have been the subject of only one study. The Tax Court found that this study, the Compunetics study, was buttressed by assumptions such as that the construction of a K-Fuel reactor was technically and financially feasible. As for taxpayer's

experts, while their post-hoc testimony is not relevant to the taxpayer's preparations for this activity, their testimony about the commercial viability of this venture was also of negligible value because of its assumptions as to material facts.¹³ The testimony also centered on the technical viability of the Koppelman process. However, the fact that K-fuel exists and can be produced is beside the point. The offering memorandum did not even make projections as to the profit-making potential of the Koppelman

¹³ The first of the three reports offered by the taxpayers, that of Lam, addressed the oil and gas revenue projections and not the Koppelman process activities. The second, authored by Pomerantz, discussed the market potential of K-fuel slurry rather than the product produced by the North Carolina plant. The Plummer and Thomas report, third was predicated on the assumption that the partnership would enter into a joint venture with a utility.

process activities. The paucity of evidence demonstrating any careful preparation for entry into commercial exploitation of the Koppelman process does not survive scrutiny under this factor.

The third of the factors is the time and energy expended by the partnership in carrying on this activity. Treas. Reg. Sec. 1.183-2(b)(3). The partnership's minimal activity goes more directly to a holding of the Tax Court we do not reach, the issue of whether this was a passive activity. However, the economic substance of the partnership is made abundantly clear from the fact that James Aronson, who oversaw the construction of the North Carolina physical plant by a contractor, appears to have been the only employee of

either the partnerships or the three corporate hierarchies set up by the promoters, who performed actual services for the partnerships rather than being a mere salaried figurehead. The general partners, Goldman and Kaye, were accountants and financial consultants. They had no familiarity with the technical process, nor did they have entrepreneurial backgrounds, and the offering memoranda informed prospective partners that they were going to take little part in the partnerships' activities. It appears that they took no part whatsoever.

The fourth factor offered by the regulations is the expectation that the assets of the partnership may appreciate in value. The record reveals that the

partnership was virtually without true assets, with the exception of the small plant, which is not argued to have more than negligible value. The Tax Court regarded the principal assets of the partnerships as the technology licenses, and noted that the offering memorandum stated that they were impossible to value. In addition, as discussed above, the validity of the underlying license to Ronodo is questionable at best, and the subsidiary licenses likewise.

The fifth factor suggested by the regulations is the success of the partnership in carrying on other similar or dissimilar activities:

The fact that the taxpayer has engaged in similar activities in the

past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

Treas. Reg. Sec. 1.183-2(b)(5). As noted above, there was no evidence that the principals of this venture had entrepreneurial expertise outside of the tax-oriented investments field. As for the partnership itself, not only did its Koppelman process activities generate losses, its oil and gas exploration activities did also.

The sixth and seventh factors cited in the regulations go to the existence and extent of long-term profitability,

which is inapplicable to the present situation, involving the initial years of the partnerships. The eighth factor addresses the extent to which the investment at issue involves a substantial investment by the taxpayer, which would suggest an emotional investment in the profitability of the activity (a form of at-risk inquiry). Here, the offering materials stipulated that the partners should have large outside incomes, in order to utilize the tax benefits from the partnerships. The taxpayers' outlay for this venture was minimal, and the deductions taken by the taxpayers at issue realized the promoters' four-to-one tax benefits projection. The ninth factor is not met here, since the taxpayers did not engage in the present activities for personal

pleasure or recreation.

The facts related to the nine factors listed in Treasury Regulations section 1.183-2(b)(1)-(9) do not support a holding that the Tax Court's conclusions were clearly in error, and inquiry into the totality of the circumstances evidences that the Tax Court, far from being in error, was clearly correct. A number of aspects of the transaction here emit a strong odor of sham. The trio of corporate hierarchies set up by the promoters to provide the "license" and "services" to the partnerships speak for themselves. Particularly absurd is the "research and development" services offered by FTRD, which was to "coordinate the activities of Koppelman himself and others with

K-Fuel experience that FTRD, or rather its sole active employee, Aronson, did not have. It is apparent that the corporate hierarchies were actually formulated as thinly-veiled means of channelling the majority of the partners' investment back to the promoters, through the promoters' equity interests in the corporations and through their salaried positions as officers and directors of the corporate entities. The economic substance of the arrangement, however, is that the promoters sold tax deductions to the partners.

The partners did not contemplate the partnerships as activities for profit not because the Koppelman process itself lacks validity -- it was no doubt carefully chosen by the promoters

expressly because it has arguable potential as an alternative energy source -- but because the business entity which was set up here was impracticable in numerous respects. The Tax Court's conclusion that "actual control rested in persons whose compensation from these partnerships depended solely on capital contributions, while they had interests in the profitability of competing ventures" (emphasis in original) is both uncontroverted and of undeniable import. There are other indications that the principals of the venture had no intention of seriously pursuing it, particularly the licensing arrangements. The imperfect documentation and non-recourse nature of Koppelman's license to Ronodo clearly show the sham nature of the transaction. The Tax Court

found also that the prices charged the partnerships for their licenses, as well as for other services, were not set by market forces, but were formulated with a view toward satisfactory return on the promoters' capital, and accepted by the partners without negotiation.¹⁴ I would argue that the fact that Koppelman later sold the United States rights to the Koppelman process for more than 20 times

¹⁴ The taxpayers' experts did not "justify this practice." The experts merely concluded that the fees charged were within the range of reasonableness. The fact that the amount of the fees might have been reasonable if they had been arrived at through market forces, however, is irrelevant to the significance of the testimony in the Tax Court that the method by which the fee was actually derived was from the promoters' client's stated expectations as to the return he wanted on his investment. This method of setting the fees had nothing to do with the "success" of the venture, since these fees were purportedly being paid to the corporate entities for their services, not to the promoters for their promotional expertise.

the price paid by Ronodo (under the most generous construction of the I license) speaks not to the entrepreneurial savvy of the promoters, but to the fact that the partnerships were known to Koppelman and the purchasers of the rights to be tax-oriented rather than potential competitors.

It was perfectly apparent to purchasers of partnership units that the partnerships dealt only with corporations controlled by the promoters, that none of the web of commitments of the partnership had been negotiated at arms' length, that the principals and contractors to the partnership had no experience in relevant endeavors, and other facts communicating the insubstantial nature of the enterprise. These partnerships were not

business ventures, they were paper montages of likely Tax Court arguments.

It does not controvert the significance of the other facts at issue to say that the income from the oil and gas activities of the partnership might have covered the expenses of the Koppelman process activities. It may be that the Koppelman process itself is commercially feasible. However, as the Tax Court clearly pointed out, it was the structure of this venture, the conflicts of interest, and other factors separate from the economic viability of the processes at issue, which demonstrate that the investors had no profit motive. The experts offered by the taxpayers who found the oil and gas projections reasonable, addressed merely the surface

question of the economic potential of the partnerships' activities. However, there was no serious intent to pursue those activities, and the purchasers of the partnership units, to whom the partnerships were marketed as tax-oriented investments, had no expectation that the partnerships would be commercially successful. The principals of this venture had no incentive to make it a success, the venture had inadequate funding to make it a success, and there is no evidence of attempts to make the venture a success after the failure of the activities originally planned, despite the fact that the partners had an obligation to fund the partnerships for the next twenty years. Viewing the above circumstances as a whole, I would affirm the Tax Court's

finding that there was no profit motive under section 183, and that SFA was engaged in a sham transaction rather than a "trade or business" entitling it to deductions under section 174.

The rules announced in Bryant support the conclusion reached in this opinion. There is ample evidence, as pointed out above, to support the conclusion of the Tax Court, and independent de novo consideration of the evidence, also as outlined above, indicates that the transaction was a sham in that it had little possible economic effect other than the creation of income tax losses.

The majority's reliance on Bryant for the proposition that the likelihood

of profit does not control the determination whether the taxpayer had a profit motive, is misplaced. The Bryant opinion states that an "unreasonable expectation of profit involves a "small chance for a large profit." While this definition fit the gold- and silver-mining at issue in Bryant, it does not describe the situation here. In addition, the question of the commercial feasibility of the Koppelman process is far outweighed by other aspects of the transaction, all of which are relevant under the totality-of-the-circumstances inquiry dictated by the regulations.

Deduction of Interest

The Tax Court should also be affirmed as to its disallowance of

deductions taken by the partners for interest on the partnerships' notes to FTRD and Sci-Teck. The taxpayers rely on Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985), for the proposition that they are entitled to take deductions for obligations which have economic substance, even if entered into pursuant to a venture lacking substance. The taxpayers assert that the interest on the partnership's notes to FTRD and Sci-Teck may be taken by them as a deduction. In Rice's Toyota World, however, the taxpayer had given a full-recourse note obligating the taxpayer to pay both principal and interest. Here, the taxpayers' note only assumed the obligation to pay their proportionate share of the principal amounts due to

FTRD and Sci-Teck. The Tax Court found that the partnerships were unlikely ever to have funds to pay their interest obligations, therefore the interest payments of the partnerships could not be said to have economic substance as to the taxpayers. The Tax Court properly concluded, under the "all events" test of Treasury Regulations section 1.461-1(a)(2), that the taxpayers were not entitled to deduct the interest on the partnerships' notes.

Penalties

I would also affirm the holdings of the Tax Court as to the penalty for substantial understatement of income tax under section 6661, and the penalty for understatement of income tax due to a

tax-oriented investment under Section
6621(c), for the reasons stated above.

APPENDIX D
IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 90-8000

JAMES KARR, and
NANCY L. KARR,

Petitioners,

versus

COMMISSIONER OF INTERNAL
REVENUE,

Respondent.

Appeal from the United States Tax Court

ON PETITION(S) FOR REHEARING

(May 7, 1991)

BEFORE: JOHNSON and HATCHETT,
 Circuit Judges and DYER,
 Senior Circuit Judge.

PER CURIAM:

The petition(s) for rehearing
filed by appellants, James and
Nancy L. Karr, is denied.

ENTERED FOR THE COURT:

/s/ HATCHETT

United States Circuit Judge

APPENDIX E

UNITED STATES COURT OF APPEALS

FOR THE ELEVENTH CIRCUIT

No. 90-8000

T.C. No. 309-87

JAMES KARR, and NANCY L. KARR,

Petitioners,

versus

COMMISSIONER OF INTERNAL
REVENUE,

Respondent.

Appeal from a Decision of the United
States

Tax Court (Georgia Case)

Before JOHNSON and HATCHETT, Circuit
Judges, and DYER, Senior Circuit Judge.

JUDGMENT

This cause came to be heard on the
transcript of the record from the United

States Tax Court, and was argued by
counsel;

ON CONSIDERATION WHEREOF, it is now hereby ordered and adjudged by this Court that the decision of the Tax Court in this cause be and the same is hereby AFFIRMED;

IT IS FURTHER ORDERED that petitioners pay to respondent, the costs on appeal to be taxed by the Clerk of this Court.

Entered: February 27, 1991
For the Court: Miguel J. Cortez, Clerk

By: /s/

Deputy Clerk

ISSUED AS MANDATE: May 15, 1991

APPENDIX F

Section 6661 provides:

(a) ADDITION TO TAX.-If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 10 percent of the amount of any underpayment attributable to such understatement.

(b) DEFINITION AND SPECIAL RULE.-

(1) SUBSTANTIAL

UNDERSTATEMENT.-

(A) IN GENERAL.-For

purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of-

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) \$5,000

(B) SPECIAL RULE FOR
CORPORATIONS.-In the case of a
corporation other than an S
corporation or a personal holding
company (as defined in section 542),
paragraph (1) shall be applied by
substituting "\$10,000" for "\$5,000".

(2) UNDERSTATEMENT.-

(A) IN GENERAL.-For
purposes of paragraph (1), the
term "Understatement" means the
excess of-

(i) the amount of
the tax required to be shown
on the return for the taxable
year, over

(ii) the amount of
the tax imposed which is shown
on the return, reduced by any

1

rebate (within the meaning of
section 6211(b)(2)).

(B) REDUCTION FOR
UNDERSTATEMENT DUE TO POSITION OF
TAXPAYER OR DISCLOSED ITEM.-The
amount of the understatement under
subparagraph (A) shall be reduced by
that portion of the understatement
which is attributable to-

(i) the tax
treatment of any item by
the taxpayer if there is
or was substantial
authority for such
treatment, or

(ii) any item with
respect to which the
relevant facts affecting
the item's tax treatment
are adequately disclosed

in the return or in a statement attached to the return.

(C) SPECIAL RULES IN CASES INVOLVING TAX SHELTERS.-

(i) IN GENERAL.-In the case of any item attributable to a tax shelter-

(I)

subparagraph (B)(ii) shall not apply, and

(II)

subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the

taxpayer reasonably
believed that the tax
treatment of such
item by the taxpayer
was more likely than
not the proper
treatment.

(ii) TAX SHELTER.-For
purposes of clause (i),
the term "tax shelter"
means-

(I) a
partnership or other
entity,

(II) any
investment plan or
arrangement, or

(III) any other
plan or arrangement,

if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(3) COORDINATION WITH PENALTY IMPOSED BY SECTION 6659.-For purposes of determining the amount of the addition to tax assessed under subsection (a), there shall not be taken into account that portion of the substantial understatement on which a penalty is imposed under section 6659 (relating to addition to tax in the case of valuation overstatements).

(c) AUTHORITY TO WAIVE.-The

Secretary may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.

Appendix G

Year	Principal Balance	Accrued Interest	Oil & Gas Revenues Applied to Notes	Portion of Oil & Gas Revenues Applied to Interest	Cumulative Total of Oil & Gas Revenues Applied to Interest
1982	\$35,493,750	\$2,129,625	\$ 16,705	\$ 2,005	\$ 2,005
1983	35,479,050	2,128,743	73,486	8,818	10,823
1984	35,414,382	2,124,863	125,275	15,033	25,856
1985	35,304,140	2,118,248	169,206	20,305	46,161
1986	35,155,239	2,109,314	230,199	27,624	73,785
1987	34,952,664	2,097,160	781,218	93,746	167,531
1988	34,265,192	2,055,912	993,885	119,266	286,797
1989	33,390,573	2,003,434	1,258,094	150,971	437,768
1990	32,283,450	1,937,007	1,598,012	191,761	629,530
1991	30,877,200	1,852,632	2,036,092	244,331	873,861

Year	Principal Balance	Accrued Interest	Oil & Gas Revenues Applied to Notes	Portion of Oil & Gas Revenues Applied to Interest	Cumulative Total of Oil & Gas Revenues Applied to Interest
1992	29,085,439	1,745,126	2,591,455	310,975	1,184,835
1993	26,804,958	1,608,297	3,281,658	393,799	1,578,634
1994	23,917,099	1,435,026	4,164,100	499,692	2,078,326